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IMPACT OF THE DOLLAR ON U.S. COMPETITIVENESS

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SUBCOMMITTEE ON ECONOMIC GOALS AND INTERGOVERNMENTAL POLICY

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IMPACT OF THE DOLLAR ON U.S. COMPETITIVENESS

TUESDAY, MARCH 12, 1985

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON ECONOMIC GOALS
AND INTERGOVERNMENTAL POLICY
OF THE JOINT ECONOMIC COMMITTEE,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room SR-418, Russell Senate Office Building, Hon. Lloyd Bentsen (vice chairman of the subcommittee) presiding.

Present: Senators Bentsen and Proxmire.

Also present: Ruth Kurtz, John Starrels, and George R. Tyler, professional staff members.

OPENING STATEMENT OF SENATOR BENTSEN, VICE CHAIRMAN

Senator BENTSEN. This hearing will come to order. Mr. Jefferson and Mr. Brinner, we are very pleased to have you this morning. We would have more membership here because they are intensely interested in this issue, but when we planned this hearing we had not anticipated that Congress would not be in session this particular part of the week.

We want to welcome you to the first of two Joint Economic Committee hearings that will explore the adequacy of U.S. trade policy. This hearing is going to examine the effects of the bloated dollar on the economy while the hearing next week will examine the effects of foreign trade barriers.

U.S. trade and U.S. trade policy are in deep trouble. U.S. exports last year fell below 1980 levels, while imports rose 40 percent. The U.S. trade deficit nearly doubled in 1983, nearly doubled again last year, and is projected by Ambassador Brock to reach as high as $160 billion this year.

There are a number of factors that are contributing to these runaway deficits, including foreign trade barriers, the international debt crisis, slow recoveries abroad, and outdated GATT rules. One of the most significant factors has been the domestic economic policy combination adopted since 1981 of tight money and wide open fiscal stimulus. That policy has produced a recovery, but it has also produced a recession, staggering budget deficits and record real interest rates—luring billions of dollars here from abroad and sending the dollar skyhigh. Since 1980, the dollar has climbed well over 40 percent in value to unprecedented heights. International

trade is like a 100-yard dash to the marketplace. And the bloated dollar has given our competitors a 40-yard headstart.

It has slapped a 40-percent tax on U.S. exports and provided a 40-percent subsidy to imports. It is cutting through our foreign trade sector like a sickle, forcing layoffs, reducing profits, and hobbling investment. By itself, the bloated dollar is adding $55 billion to current trade deficits, and accounts for two-thirds of the trade balance deterioration since 1980.

The bloated dollar has cost the United States 2 million jobs since 1980, according to a report on the impact of the dollar being released this morning. Prepared by Data Resources, Inc., the report notes that the dollar has cut 5.1 percent from U.S. investment and 4 percent from growth since 1980—a loss of income worth nearly $600 per person this year.

As the DRI report makes clear, this gutting of America's foreign sector has repercussions reaching into every aspect of our economy. Industry profits will be $30 billion less this year due to the deficit and the budget deficit will be $67 billion larger than it would have been with a stable dollar. The rising dollar has pushed production costs down abroad. In Japan, for example, manufacturing costs are only 71 percent of U.S. levels.

Mr. Jefferson, I had to fly to Texas yesterday for a meeting and I had to use a helicopter in order to make my connections. I spent about 30 minutes there in that meeting. While making the round-trip, one of the things I did was fly in a new French helicopter. A comparable helicopter in the United States sells for 50 percent more. This points up the problem in the difference in currency values, in that case, the French franc and the U.S. dollar.

The administration, I don't believe, is grappling effectively with the bloated dollar. And, in light of growing worldwide protectionism, that is not its only failure in trade policy. The major result of these failures is that a number of major American industries have lost their international trade edge since 1980. They are selling less abroad now than their competitors sell here. They are rapidly losing, and in many cases have lost their international competitiveness.

I'd like to show you this chart and just what's happened to some of our leading industries.

In semiconductors, in 1980 we had a $140 million trade surplus. In 1984, a $2.2 billion deficit. Electronic components—there's one we've been a leader on for a long time. In 1980, we had a $470 million surplus; in 1984, a $2.7 billion deficit. Photographic equipment, a $700 million surplus in 1980; a $300 million deficit in 1984. General aviation aircraft—we've always been out front there—a $200 million surplus in 1980 turned into a $420 million deficit by 1984. You can go right on down the list.

[The chart referred to follows:]

U.S. INDUSTRIES
LOSING INTERNATIONAL TRADE ADVANTAGE

	BALANCE OF TRADE	
	1980	1984
SEMICONDUCTORS	$140 MIL.	$-2,200 MIL.
ELECTRONIC COMPONENTS	470	-2,700
PHOTOGRAPHIC EQUIPMENT	700	-300
GENERAL AVIATION AIRCRAFT	200	-420
SHIPBUILDING AND REPAIR	370	-185
CONFECTIONERY PRODUCTS	60	-74
TEXTILES	450	-2,200
LEATHER GOODS	55	-90
HOUSEHOLD APPLIANCES	230	-1,100
TELEPHONE EQUIPMENT	140	-950
MUSICAL INSTRUMENTS	50	-220
TOOL AND DIE MACHINE TOOLS	50	-20
COMPUTER CONTROLLED MACHINING CENTERS	6	-150

Senator BENTSEN. When we lose those sales and foreign market share, when foreign firms move in with their distribution centers and with their retail outlets, when they get their marginal costs down that much, once you've lost your market share, it's a tough thing to get back. It's not an easy thing to turn around. So what we're seeing now is an erosion of American production and productivity. The people who think we can manage just by being a service economy are wrong. That's not going to cut it. This country cannot remain a great nation unless it keeps a substantial manufacturing base. Moreover, many of those services are not exportable services. Many of those things are done for consumption within our own country. They don't earn a cent abroad.

So these are the problems we face. I think you gentlemen will make a major contribution with the information you're going to present this morning. I'd like to welcome this morning Mr. Roger Brinner, the chief economist of DRI; and Mr. Edward G. Jefferson, chairman of the board of Du Pont, to this hearing. I thank both of you for appearing today and you, Mr. Brinner, for preparing this very excellent report.

Now I'd like one of you gentlemen to proceed, whichever.

Mr. JEFFERSON. Shall I lead off, Senator?

Senator BENTSEN. That will be fine, Mr. Jefferson.

STATEMENT OF EDWARD G. JEFFERSON, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, E.I. DU PONT DE NEMOURS & CO., WILMINGTON, DE

Mr. JEFFERSON. Mr. Vice Chairman, Senator Proxmire, I guess the recent public opinion surveys suggest that Americans are generally upbeat about the Nation's economy, and there is a great deal to sustain that view. Following the exceptionally deep recession of 1982, we have achieved a strong rebound. Unemployment has eased to about 7 percent and the double digit inflation that prevailed just a few years ago has been reduced to about 4 percent.

While these are positive signs, other indicators are less promising. The 5-year compound real growth rate of the economy has been a less than impressive 2.1 percent. The 5-year real growth rate for industrial production has been only about 1.4 percent. Federal budget deficits are unacceptably high and the Nation's trade deficit has tripled since 1982. While interest rates have eased somewhat in recent months, they are still much higher than they should be, given the relatively low level of inflation. The exceptional strength of the U.S. dollar severely impairs the ability of U.S. producers to compete abroad and at home. The trade deficit is at a dangerous level.

Our economic problems are interrelated. Budget deficits and a generally restrictive monetary policy are helping to sustain high inflation-adjusted interest rates. These interest rates, the comparative strength of the U.S. economy, low inflation, and the "safe haven" psychology have attracted large inflows of foreign capital, increasing and supporting the value of the dollar. The trade weighted composite index of the dollar exchange value is up now almost 60 percent from mid-1980, when the current excessive appreciation started to build. This abnormal strength of our currency

means that dollar-denominated costs of production here in the United States have become much higher than the costs of production in Europe, Japan, and many other countries. As a result, our trade balance has deteriorated sharply.

While much has been said about the United States being a safe haven for foreign capital, it should be noted that foreigners get 3 to 4 percent higher real interest rates for U.S. investments compared with the investments in their own countries, and this to a degree compensates for the risk of sudden currency shifts. More about that in a little while.

I do not mean to imply that all of domestic industry's competitiveness problems are the result of the abnormal strength of the dollar. There are other factors that come into play. These include different tax treatment and a lower user cost of capital enjoyed by our competitors overseas. But the excessive appreciation of the dollar is the prime handicap. There is a clear correlation between the rising dollar and the growth of our trade deficit. All U.S. industries competing in world markets are vulnerable under the present conditions. The excess value of the dollar as a trading currency is too great to be overcome by improved technology or by better management practices.

Core manufacturing industries have been especially hard hit, but the damage has by no means been limited to the so-called smokestack industries. No area of U.S. industry is immune to the overwhelming currency advantage of foreign countries. If you look at the industries shown on your chart, Senator, in pharmaceuticals, electronics, communications, and other advanced industries that are often seen as our hope for the future, a declining competitiveness is also evident. The high technology sector, for example, has seen a $27 billion trade surplus in 1980 deteriorate to just $5 billion last year. And, of course, agriculture—we've been hearing a lot about that—the basic element of U.S. trade—also feels the impact. In 1981, exports of farm products from the United States were $43 billion; last year they had fallen to $38 billion. It is estimated that our worsening trade performance over the past few years has already cost us about 2 million jobs.

For several years prior to 1980, the U.S. chemical industry had begun generating a large and growing trade surplus, well in excess of $10 billion annually. It reached as much as $13 billion. But since the dollar began to rise, the surplus has been eroded by about 35 percent. In my own company this has reduced our sales volume and had a depressing effect on selling prices in many businesses. It has forced us to shut down U.S. facilities resulting in a loss of jobs, and I would emphasize that these facilities are world-class facilities. They are as efficient as any and yet they have had to go down. It has put increasing pressure on us to make new investments outside the United States rather than here at home.

To take one particular example, we are the largest producer of manmade fibers in the world with sales last year of $4.7 billion. Our position in the world fibers industry has been substantially impaired since 1980 by a dramatic increase in imports of apparel. In 1980, about one-fourth of the clothing sold in the United States was imported. This rose last year to 43 percent. Textile imports in-

creased just last year alone by one-third, despite an essentially flat consumption market.

An important part of this market is polyester fiber. Sales of this fiber are a little more than $11 billion a year worldwide. Just 5 years ago, about one-third of the world's polyester fiber was produced here in the United States; today that has dropped to one-fourth and is still falling.

As a result of such trends in the apparel business, we and other companies have been forced to idle efficient fiber production facilities as the domestic market needs are increasingly being met by foreign suppliers. The textile industry alone has lost some half a million jobs in the past 4 years.

Damage has not been limited to the fibers business, however. Looking at Du Pont again, most of our other businesses are suffering competitiveness problems due to the abnormal strength of the dollar. We see it in medical x ray film. Here, oversea competitors who are not more efficient have been able to offer lower prices or other incentives to gain market share. Similar problems have arisen in commodity chemicals, engineering plastics, and electronic products businesses shown on the chart. If the dollar's value is not moderated to more realistic levels we will face further curtailment of production capacity with additional loss of jobs. Even where foreign plants are less modern and less efficient than their U.S. counterparts, the currency misalignments more than compensate and give foreign plants a competitive advantage.

These trends carry with them unpleasant consequences for U.S. industry as a whole and for employment. In many industry segments reinvestment here in the United States does not make economic sense. Prospects for a continuing strong dollar will discourage U.S. manufacturers from building new plants in this country and encourage investment abroad; and this in spite of the long timeframes that are involved in many of the major industry plant construction. Well, such investment decisions will result in long-term export of jobs and they will result in loss of tax revenues.

We must not allow large segments of our industrial base—and millions of jobs—to move offshore. What can we do about it?

While the abnormal strength of the dollar has several roots, a major contributor has been the high inflation-adjusted interest rates resulting in part from the Federal budget deficits. Because of our fiscal laxity, we have been forced to depend on a generally restrictive monetary policy to curb inflation. If we bring the Federal budget under better control it will enable the Fed to continue moves to relax the money supply, and thereby further reduce interest rates and help restore more normal currency relationships.

Getting control of the budget obviously is very difficult. One thing is sure. We cannot grow out of our problems. We cannot solve them with any quick fix. A multiyear deficit reduction program with broad bipartisan support are essential to get the job done.

The 4, 3, 2 program that has had much discussion and has substantial support is a good place to begin. That is, we should reduce the deficit to no more than 4 percent of GNP in 1986, 3 percent in fiscal 1987, and 2 percent in fiscal 1988. In setting out to do this, priority should be given first to spending control—not only of mis-

cellaneous Government expenses, but also the big ticket items including defense and entitlements. Projected increases in defense expenditures can be moderated in ways that do not threaten national security. By limiting the growth of Social Security and other nonmeans-tested entitlements to a percentage below the full change in the CPI, considerable savings could be achieved. An across-the-board freeze for 1986 has a great deal to commend it.

If expenditures cannot be reduced to the extent needed to bring the deficit down to the several-year goal that I mentioned, some revenue increases may have to be considered. In evaluating proposals for more revenues or to reform the tax system, it is critically important to avoid solutions that would worsen the problem through further impairing our international competitiveness and thereby retarding economic growth at home. There are several yardsticks that we are applying to this.

We ask ourselves: Do they help bring into better balance incentives for savings and investment with those for consumption? Do they encourage domestic capital formation essential to productivity improvement and global competitiveness and economic growth? Do they stimulate private investment in research and development and technological innovation? Finally, do they enhance or impede the ability of U.S. companies to compete effectively in global markets? Those are several litmus tests that should be applied to evaluating tax increases.

While tax policy matters are too broad a subject to consider in full this morning, let me underline the effect of taxes on trade by citing one example. A recent study of border taxes concluded that the use of transactional taxes, such as the value-added tax, does give some countries a cost advantage in foreign trade. Under GATT rules, as you know, such taxes are rebatable at the border and this gives several European countries a cost advantage of better than 4 percent—and this is over and above the advantage we've been addressing that derives from present currency misalignments. As we consider revenue increase and tax reform proposals, we had better keep this in mind.

The problem of the overvalued dollar is not only that it puts the United States at a competitive disadvantage, but also that the currency relationships are in a fact unstable and the dollar could tumble at any time. A rapid drop could produce renewed inflation followed by a more restrictive monetary policy, in turn, eventually leading to recession. So we must wean ourselves away from the deficit addiction. We have to stop the use of economic pep pills.

Regaining control over the Federal budget is the single most important step we can take to resolve the currency misalignments. At the same time there are other actions that would help on the trade deficit. Protectionist measures—increasingly advocated as trade problems worsen—should be avoided if at all possible. However, other nations are using nontariff barriers to protect their markets. We must insist that our trading partners provide reasonable access to their markets if we are to continue to provide them access to ours.

With our merchandise trade deficit well in excess of $100 billion and our reliance on capital inflows to finance nearly half of U.S. net investment, we are behaving like a boy on a spending spree

with his dad's credit card. The day of reckoning surely will come. Perceptions are, unfortunately, confused because the capital inflows and the rising dollar do give many a false sense of security. However, if we do not succeed in correcting the dollar and trade problems, pressure for major intervention will obviously build.

We are dealing with an interconnected set of problems—budget deficits, currency misalignments, international competitiveness difficulties, and trade deficits all have linkages. Hence, our economic and trade policies have to be better coordinated. In spite of the fiscal policy deficiencies, monetary policy must focus both on continued containment of inflation on the one hand and correcting the currency exchange rate factors which are impairing our international industrial competitiveness on the other.

Not long ago the problem might have seemed less severe. Twenty years ago imports of goods constituted only 6.3 percent of the U.S. market, and imports and exports together amounted to only 6.5 percent of GNP. Today we import almost 15 percent of our goods, and imports and exports account for 12 percent of the total economy. Last year imports captured about one-third of the increase in domestic growth, including one-fourth of the increase in consumer spending for goods and almost one-half of the increase in the nonmotor-vehicle capital spending. We are a part of the world economy today and every American has a stake in the worldwide competitiveness of our industries. The times call for bipartisan leadership in this matter and prompt, decisive action.

Senator BENTSEN. Thank you, Mr. Jefferson.

I want to intervene at this moment to recognize the presence of the distinguished former chairman of the Joint Economic Committee, one of the most careful and learned students of the American economy. We are very pleased to have him here and I'd like to call on him for any comments he might have. Senator Proxmire.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Thank you very much, Senator Bentsen, and I want to congratulate you on calling these hearings. I can't think of a more important area of inquiry for the Joint Economic Committee, more important to the economy of our country or more difficult to handle. I think, Mr. Jefferson, your statement is a fine statement in setting forth the problem here.

I'd just like to add one thing that I hope that you and Mr. Brinner can discuss. I think we have to recognize that, as you say—you said in part at least—that we benefited from these deficits. We have; 1984 was the best year we've had in 33 years. Let's not kid ourselves. The enormous stimulus that three successive deficits of $109 billion, $195 billion, $175 billion had a lot to do with that. We're probably going to have another good year with a deficit of $222 billion. That means that profits will be higher and employment will be better, the economy will do well.

That also means that the flip side which you've just been telling us about our losing jobs abroad, those jobs haven't disappeared; they have gone abroad. And the great American economy with this enormous deficit has acted as a locomotive to pull much of the rest

of the world out of the trouble they were in. So that's another element here that we have to be concerned with.

But I think that you and the Senator are exactly right, that we have to get this under control, in spite of the fact that there's a temporary benefit, a good one, from these deficits. There's obviously a price to pay.

I might point out that the chart that you have, which is a most helpful chart—now that's the kind of chart that really talks business to Members of Congress because we look down and see our State. You say in Texas they're losing 68,000 jobs and in Wisconsin they're losing 29,000 jobs. I think you would agree with me that this doesn't really state the whole picture by any means because the area that loses the most is agriculture. That's the big exporter. That represents a very large proportion of it and, of course, they're not manufacturing jobs which is what this records. Both Texas and Wisconsin are losers there and I noticed the States that have lost the least, included among them, are Montana, Minnesota, Nebraska, South Dakota, North Dakota, and they are taking it on the chin perhaps as badly as any State, maybe worse, because of the deficit, because it's hammered down farm prices and absorbed much of their market. So this is a terrific problem for all of us and I think it's one of the most significant hearings the subcommittee has had in a long time. Thank you, Senator Bentsen.

Senator BENTSEN. Thank you very much, Senator Proxmire.

Mr. Brinner, looking at your report, I'm wondering if we could have you come back with a later report on agriculture and give us something specific on that, as well?

Mr. BRINNER. Yes.

Senator BENTSEN. We're very pleased to have you here this morning, if you would proceed now with your statement.

STATEMENT OF ROGER E. BRINNER, CHIEF ECONOMIST, DATA RESOURCES, INC., LEXINGTON, MA

Mr. BRINNER. I will be summarizing both the qualitative and the quantitative conclusions of this report—and it itself is a summary of our larger studies in different areas—that will be shared with the subcommittee later.

I do thank you for the opportunity to appear here today, Mr. Vice Chairman and Senator Proxmire, and I certainly concur with Mr. Jefferson that it would be a very serious mistake to conclude from the strength of the 1983–84 recovery that the United States is fully attaining its economic potential. We have inadvertently placed ourselves in a very weakened state as an international competitor and we are importing goods and exporting IOU's at a record pace.

Contrary to assertions by some confused optimists, the speed and pervasiveness of the global and domestic market share losses by American firms are neither unavoidable nor desirable parts of the normal process of economic evolution. The present agony of many American manufacturing firms is an evolutionary mutation engendered by the extraordinary value of the U.S. dollar, itself a clear result of unbalanced monetary and fiscal policies.

Even after adjusting for our superior inflation performance, since 1980 the dollar has appreciated over 40 percent against a trade-weighted average of 15 major currencies. As of today, this appreciation has cost the United States just under 2 million jobs, and approximate loss of 4 percent of real gross national product and of 9 percent in industrial production, and Federal budget and trade deficits are each approximately $60 or $70 billion larger than they might have been. Our export sales in volume terms are 15 percent lower and our imports 15 percent higher than would have been the case with a normal dollar value in line with our relative cost position.

As indicated in the exhibit on the State-by-State manufacturing job losses, these radical losses hit all regions. Of the 13 States with a loss greater than 7.5 percent of their manufacturing employment, 7 are in the South, 4 are in the Northeast, and 2 are in the West. That is contrary to the notion that it's just one isolated area, the so-called "Rust Bowl," that is suffering even on a manufacturing basis. You might notice that the top two States on a percentage basis are North Carolina and South Carolina, 13.3 percent loss in manufacturing jobs relative to what they could have achieved due to this exaggerated value of the dollar since 1980.

The principal cause of the dollar's extraordinary rise is the extremely high rate of interest in the United States relative to our international trading partners. The inflow of foreign capital and the reduction in net exports in our open economy makes room for private investment but a larger fraction of the Nation's assets are then owned by foreign investors. Senator Proxmire, you spoke of the fact that this fiscal stimulus has given us very good growth in 1984 and would give us fairly good growth in 1985. That's true. But like a homeowner who's taken out his fourth mortgage and is spending it freely, we're allowed a fourth mortgage because we're willing to pay 6, 7, 8 percent beyond the prevailing rate of inflation. Our creditors can't find anyplace else that they would rather lend so they think they're going to take a chance on us and we're willing to pay very generous terms. But we owe that money and we are going to have to pay that rate of return to all of our creditors, many of whom are overseas.

The U.S. current account has swung from a surplus in the spring of 1982 to a deficit of nearly $100 billion 1984, with no improvement in sight. This is not primarily due to the strength of the recovery here and the weakness abroad. If that were the case, imports would not be capturing ever larger market shares in the United States while American workers are laid off. The exaggerated value of the dollar is responsible for two-thirds of the balance of payments deterioration; contrasting recovery cycles, the LDC debt crisis, and OPEC's recent woes together account for the other third.

The dollar's appreciation is driving a massive wedge between domestic and foreign production costs. In manufacturing industries Japan's unit labor costs averaged just 60 percent of U.S. labor costs in 1984, while Germany's were 95 percent of the U.S. level. Only 5 years ago, Japanese unit labor costs were over 90 percent of the U.S. level. Reflecting America's emerging competitive disadvantage, imports captured 40 percent of the real growth in demand for traded goods last year and the dollar's rise, as you both noted, has

also devastated industries that are heavily dependent on exports, such as agriculture.

By changing costs, the dollar's strength is motivating the undesirable structural changes the vice chairman mentioned. Expecting the dollar to remain overvalued, manufacturing companies are shifting production abroad and outsourcing, or purchasing components and finished products from foreign suppliers. U.S. exporters are forced to abandon oversea markets where sales are now very disappointing. Foreign companies are building distribution networks here, and by increasing their export volume, these foreign producers are achieving new economies of scale that will enhance their future price advantage.

The Nation will pay a continuing price for these aberrations. Our labor force and our manufacturing capacity are utilized today at levels that history would equate with a recession. We feel good today compared to 1982, but not compared to history. Our national capital formation has been retarded and misallocated. This implies heavy future costs in lost productivity. This means a lower standard of living that we will all recognize in the future.

Unfortunately—and you have my sincere sympathy here—the policies which have created this situation are so thoroughly imbedded that great skill will be required to extricate the United States without creating a recession or, in some cases, cutting back U.S. capital formation. American manufacturers and the service industries which sell to them have been severely handicapped by high-post-tax costs of funds relative to competitors in Japan. This disadvantage has been only mitigated by the investment incentives created by the 1981 ERTA and 1982 TEFRA legislation. These differentials show up in subpar investment by the United States.

Given these difficulties, it is extremely unfortunate that many tax reform proposals under consideration today would weaken domestic investment by exchanging low-powered corporate rate cuts for high-powered incentives such as the equipment and research and development tax credits. Still other tax proposals would make the even greater mistake of raising total corporate taxes while cutting personal taxes again. This shift of cash flow from the corporate sector to the household sector would reduce U.S. savings and U.S. investment below levels which are already low by international standards.

The Federal budget deficit is a problem because it is inhibiting U.S. asset accumulation. Fiscal policy adjustments must be made with this in mind as new initiatives encompassing both tax reform and deficit closing are considered. The Nation simultaneously requires supportive monetary policy which tempers zeal for elimination of inflation with concern for accommodating a full measure of real growth and for a reasonable foreign exchange value of the dollar. Domestic policies today must include a full consideration of their implications for our international competitive position.

These remarks summarize on a largely qualitative basis the findings of our studies. I would like to just briefly go through some of the hard data we have assembled on this issue of the U.S. international competitiveness. If you're trying to follow the exhibits and my comments I will be moving now to page 9.

The first message from the data is that we are no longer dominant in world markets. Our market share of world trade has fallen to near parity with Germany and Japan, countries with gross national products only one-fourth to one-third the size of the United States. The exhibits on pages 10 and 11 show you graphically how those market shares have changed. Japan has been the clear winner and the United States and Common Market the clear losers in the international competitive battle.

A second aspect of the declining U.S. competitive position is that U.S. exports have to a great extent become commodities on the world market. Manufactured goods have tended to be forced to compete on the basis of price alone rather than distinctive qualities or technical superiority.

The Europeans and Japanese have spent the past 40 years investing in new plant and equipment at a rate substantially higher than the United States, creating productive capacity that rivals ours in scale and quality of output.

The third conclusion to emerge from the data is that although the average productivity of the American worker has continued to rise, productivity in the rest of the world has nearly caught up by growing much more rapidly. Equally important, at current exchange rates, we Americans are overpaid relative to our competitors. On the exhibits on pages 13, 14, and on for the next five pages you can see some of that. The graph on page 17 is directed specifically to output per hour in manufacturing and there you can note, for example, that in 1960 the Japanese output was only 20 percent of ours per person in manufacturing. Today, with their embodiment of our management techniques, our technologies and access to our markets, that's risen to nearly 85 percent.

The fourth conclusion from the data is that, relative to Japan, the U.S. real-post-tax cost of funds has typically been substantially higher. On the average for the past decade, the U.S. cost has been 5.1 percent and the Japanese only 0.1 percent. That's the real cost of funds. Take the cost of bonds, for example, subtract out the tax deduction that's allowed and then subtract the inflation rate, combine that with the cost of equity allowing for no dividend deductibility, combine those two and you get the U.S. cost, 5 percent on average over the past decade beyond the rate of inflation after taxes; Japan, nil.

The current costs of labor and capital in the United States are inconsistent with the current strength of the dollar. That's what I mean by an overvalued dollar. Our manufacturing costs are far too high. If you add together all three categories—labor, capital, and energy—Japanese total manufacturing costs in 1984 were only 71 percent of those in the United States. This implies that the exchange rate would need to have been approximately 168 yen per dollar rather than 237 on average for 1984 in order to equalize long-term manufacturing costs between the two countries. This margin between actual exchange rates and the manufacturing cost-equilibration rate has provided the Japanese with high profit margins in an expanding market. These profits will finance future investment and even greater competitive pressure.

How can policy be adjusted? Monetary and fiscal policies do set the tone for the U.S. economy on a competitive international basis.

I don't believe that our policy formulation has caught up with the realities of an open economy in which we now trade. We need to be constantly aware of the linkage between policy actions in Washington and the problems faced by American industry competing for global customers.

The large Federal deficit, as I noted at the beginning of my remarks, current and prospective, is the primary cause of today's high interest rates. Nominal long-term interest rates are not high today because of inflation fears. The Fed has established its credibility there. The numbers speak for themselves, with inflation now down to 3 percent on most indexes and looking like it will stay there. Nominal long-term interest rates are high today because the credit market is expected to remain imbalanced given a persistently large Federal deficit and thus we have high real interest rates today that are expected to persist. That gives us an interest cost some four points above that of our principal competitors and explains something on the order of 30 percent of our exchange rate overvaluation.

Other things equal, this high real cost of funds has three major detrimental impacts on long-term growth prospects. First, the high hurdle rate required for investment projects implies less capital formation will take place. Second, net foreign investment will finance approximately 40 percent of the net expansion of the Nation's capital stock; the future returns on that stock will therefore accrue abroad, a substantial and growing drain on future national income. Third, the unreasonable strength of the dollar will continue unreasonably to divert the employment and output mix of the Nation away from manufacturing, a sector which offers the highest real productivity to the economy.

Not all deficit cures appear to be productive. Although the deficit is clearly bad for U.S. competitiveness, some deficit cures would be counterproductive. In particular, any policy that raises the cost of capital may well handicap American industry as much or more than it helps. Recall that the deficit is itself harmful because of its impact on interest rates and hence on U.S. asset accumulation. The major thrust of deficit reduction should come through lower growth in the entitlement programs such as Social Security, a reduction in the inflation-indexation of the personal income tax, and a hard-nosed look at the defense budget in areas such as retirement benefits. Reductions in these particular expenditure and transfer programs and higher personal taxes will increase the national savings and investment pool. For every dollar the deficit is reduced through such steps and hence funds are freed for private investment, only a fraction—5 to 10 cents—would be cut from private savings due to lower posttax, posttransfer household income. The net gain in national savings would thus be 90 to 95 cents per dollar of deficit reduction.

In contrast, a net increase in business taxes would tend to reduce capital formation because the corporate sector has a very high propensity to save and invest. The loss would be particularly great if taxes were increased by eliminating high-powered investment incentives such as the equipment and R&D tax credits. According to our best econometric analysis, each dollar of Federal corporate tax revenue raised through lower equipment tax credits would cut cap-

ital spending by approximately 55 cents; each dollar raised through a weaker R&D credit would cut R&D programs by $1.20. Even a lower powered change, such as an increase in the statutory corporate tax rate, would reduce nonresidential investment by over 30 cents for each dollar of corporate tax revenue raised.

These aren't black box answers. These make common sense because the relative sizes of these "bang-for-the-buck" estimates reflect the extent to which each program acts at the margin of investment decisionmaking, benefiting or restraining new investment rather than also altering the taxation of capital which is already in place. For example, the R&D credit, if it were made applicable to increases in current spending beyond a base-year period, would logically have the greatest leverage; the equipment credit on all new investment has less potency but is still stronger than changes in the overall rate.

This bang-for-the-buck analysis suggests that if you were worried about efficiency losses due to differential taxation of alternative investments, and therefore, wanted to equalize taxation on structures, for example, with that of equipment, the appropriate answer would be to extend credits to plant expenditures and to raise statutory corporate tax rates or personal tax rates to compensate for the revenue lost. The only other option—and I know this is becoming increasingly difficult—is to find some other expenditure to cut to finance the plant tax credits.

As the United States attempts a transition toward greater fiscal restraint, our trading partners should be encouraged to shift moderately toward stimulus in taxation, expenditure, and financial policies. The best global configuration would be a net shift toward fiscal restraint and a simultaneous net shift toward greater monetary stimulus. The former would expand the global supply of savings; the latter would cut the costs of funds and support final demand to encourage the private investment demand for these funds.

At the same time, the United States must aggressively push for reciprocity in access to goods and services markets, respect for proprietary technologies, and open capital markets. The United States must not let our fully mature industrial trading partners plead "domestic political constraints" as reasons for limiting U.S. sales of agricultural goods, telecommunications apparatus, business services, and other potentially strong U.S. export areas. This is particularly unfair when those industries receive open access to U.S. and third country markets. As a case in point, if the United States can open its auto market fully to Japan, given the tremendous threat this poses to employees and shareholders in the large U.S. auto industry, then Japan cannot ask for shelter for its industries, mature or under development.

A logical, but admittedly extreme, answer to a country which does not deliver reciprocal access might be an across-the-board tariff on U.S. imports of all of the recalcitrant partner's products, with the tariff revenues split between rebates to the general U.S. taxpaying public (household and corporate) and export subsidies on U.S. goods shipped to that country. The rebate would partially compensate the American consumer and producer for the higher cost of goods due to the tariff, and the export subsidies would partially

compensate American industries for their burden in competition with that country in other markets. The tariff and the U.S. export subsidy would anger our alleged "partner," but they should also build political pressures within that country to eliminate the shelters for isolated industries.

In summary, given our natural resources, the United States is not nearly as competitive internationally as it has been in the past or could be today. Our position is handicapped by the overvalued dollar, inadequate capital formation, and insufficient bargaining pressure on our trading partners to grant reciprocal access to their markets and technologies.

The pervasive losses of market share by American firms and the traumatic shutdowns of domestic manufacturing capacity are avoidable mutations of the normal evolution of an industrial economy. To put the Nation back on its optimal growth path, the United States must catch up with the realities of an open global economy. Our actions must be as competitively tuned as those of our strongest competitors.

Thank you very much.

[The report entitled "The United States as an International Competitor," referred to by Mr. Brinner, follows:]

Joint Economic Committee
Subcommittee on Economic Goals
& Intergovernmental Affairs

THE UNITED STATES AS AN INTERNATIONAL COMPETITOR

Prepared by Data Resources, Inc.

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THE UNITED STATES AS AN INTERNATIONAL COMPETITOR

OVERVIEW

It would be a serious mistake to conclude from the strength of the 1983-84 recovery that the United States is fully attaining its economic potential. A national unemployment rate above 7% and rapidly expanding losses of domestic sales to imports are undeniable signs that the U.S. labor and capital resource base is not being allowed to make its full contribution. We have inadvertently placed ourselves in a weakened state as an international competitor, and we are importing goods and exporting "IOUs" at a record pace. Measured by relative costs, market shares, or productivity levels, the U.S. is far less competitive today than at any time in the post-war period. We have lost much of our technological advantage and our costs are higher than those of key competitors.

The speed and pervasiveness of the global and domestic market share losses by American firms are neither unavoidable nor desirable parts of the normal process of economic evolution. The present agony of many American manufacturing firms is an evolutionary mutation engendered by the extraordinary value of the U.S. dollar, itself a clear result of unbalanced monetary and fiscal policies.

In early 1985, the dollar has soared to record heights on foreign exchange markets. In late February, the dollar set new records against the Canadian dollar, the British pound, the French franc, and the Italian lira, while reaching a 13-year peak against the West German mark. Even after adjusting for our superior inflation performance, since 1980 the dollar has appreciated over 40% against a trade-weighted average of 15 major currencies. As of today, this appreciation has cost the U.S. just under 2

million jobs, an approximate loss of 4% in real gross national product and of 9% in industrial production, and federal budget and trade deficits approximately $60-70 billion larger than they might have been. Our export sales are approximately 15% lower and our imports 15% higher than would have been the case with a normal dollar value in line with our relative cost position.

The principal cause of the dollar's extraordinary rise is the comparatively high real rates of return available on investment in U.S. debt instruments. In turn, high investment yields reflect an unfortunate policy mix of extreme, short-run fiscal stimulus and forced monetary restraint. With federal budget deficits absorbing a large share of the nation's saving, high real interest rates equilibrate the supply and demand for funds by inducing capital inflows from abroad and inhibiting U.S. outflows. In a closed economy, federal deficits crowd out private investment through higher real interest rates. In an open economy, however, a second type of crowding out occurs via an appreciating real exchange rate crowding out net exports. The inflow of foreign capital and the reduction in net exports in an open economy makes room for private investment, but a larger fraction of the nation's assets are then owned by foreign investors.

The vigorous U.S. expansion in 1983 and 1984 belies a serious imbalance in the trade sector. The U.S. current account has swung from a surplus in the spring of 1982 to a deficit nearly $100 billion in 1984, with no improvement in sight. Most of the deterioration can be traced to the manufacturing sector, where our trade balance shifted from a surplus of $20 billion at the beginning of 1981 to a deficit of $79 billion in 1984. This is not, as some would allege, primarily due to the strength of the recovery here and the weakness abroad. If that were the case, imports would not be capturing even larger market shares in the U.S. while American workers are

being laid off. The exaggerated value of the dollar is responsible for two-thirds of the balance of payments deterioration; contrasting recovery cycles, the the LDC debt crisis, and OPEC's recent woes together account for the other third.

The dollar's appreciation is driving a massive wedge between domestic and foreign production costs. In manufacturing industries Japan's unit labor costs averaged just 60% of U.S. labor costs in 1984, while Germany's costs were 95% of the U.S. level. Only five years ago, Japanese unit labor costs were over 90% of U.S. costs, while German costs were nearly 60% above the U.S. level. Reflecting America's emerging competitive disadvantage, imports captured 40% of the real growth in demand for traded goods last year. The dollar's rise has also devastated industries that are heavily dependent on exports, such as agriculture.

By changing relative costs, the dollar's strength is motivating undesirable structural transformations in the U.S. economy. Expecting the dollar to remain overvalued, manufacturing companies are shifting production abroad and outsourcing, or purchasing components and finished products from foreign suppliers. Meanwhile, U.S. exporters are abandoning overseas markets where sales have been disappointing. Such changes are not easily reversed. Nor can a dollar correction fully reverse the penetration of imports in the U.S. market. Foreign companies are building distribution networks, gaining a foothold in the U.S. market. By increasing their export volume, foreign producers are achieving new economies of scale that will enhance their price advantage.

The nation will pay a significant price for these aberrations in our economic development. Our labor force and much of our manufacturing capacity are utilized today at levels which history would equate with a recession. Our national capital formation has been retarded and misallocated, implying heavy future costs in lost productivity. Equally

important, much of the net investment which has occurred has been financed by foreign capital which will be owed an exceptionally high return unless the U.S. unexpectedly returns to double-digit inflation. This does imply a lower U.S. standard of living.

Unfortunately, the policies which have created this situation are so thoroughly imbedded that great skill will be required to extricate the economy without creating a recession or, in some cases, cutting back U.S. capital formation. American manufacturers, and the service industries which sell to them, have been severely handicapped by very high post-tax costs of funds relative to competitors in Japan; this disadvantage has been only mitigated by the investment incentives created by the 1981 (ERTA) and 1982 (TEFRA) legislation. These differentials show up in subpar investment by the U.S. and hence a weaker technology base and slower expansion of our standard of living than could be achieved with more competitively-tuned policies.

Given these difficulties, it is extremely unfortunate that many tax reform proposals under consideration today would weaken domestic investment by exchanging low-powered corporate rate cuts for high-powered incentives such as the equipment and research-and-development tax credits. Still other tax proposals would make the even greater mistake of raising total corporate taxes while cutting personal taxes: this shift of cash flow would reduce U.S. savings and investment below levels which are already low by international standards.

The Federal budget deficit is a problem because it is inhibiting U.S. asset accumulation. Fiscal policy adjustments must be made with this in mind as new initiatives encompassing both tax reform and deficit closing are considered. The nation requires steady reduction of the Federal budget deficit through a balanced program of expenditure cuts and carefully selected tax increases. The nation simultaneously requires supportive monetary

policy which tempers zeal for elimination of inflation with concern for accommodating a full measure of real growth and for a reasonable foreign exchange value of the dollar. Domestic policies must include a full consideration of their implications for our international competitive position.

THE WEAKENED U.S. COMPETITIVE POSITION

What Does "Competitiveness" Mean?

While the phrase "U.S. Competitiveness" has become commonplace in business and policy discussions, there is insufficient agreement on its definition, on its proper measurement, and on the appropriate policy responses to competitive problems.

The American Heritage Dictionary (Houghton Mifflin, 1981) defines competition as "a striving or vying with another for profit, prize, position, or the necessities of life; a contest, match or other trial of skill or ability; the rivalry between two or more businesses striving for the same customer or market." Thus. it is reasonable to define the debate as a discussion of how well industries based in the U.S. match up with similar industries in the industrial and developing worlds in the competition for customers and in the creation of national income. A successful competitor is presumably one who achieves a large market share, who at least defends and perhaps expands this share, and who achieves a stable and satisfactory return on sales to customers.

There are both static and dynamic apsects to such definitions. It is worthwhile to measure how well we are doing today in absolute terms, and it is also worthwhile to measure whether we are doing as well today as we did yesterday and as we are likely to do tomorrow.

It is both a micro and macro issue. While it is important to understand how well the U.S. is doing in the aggregate internationally, the performance of individual industries must also be understood.

Finally, it is useful to make global comparisons and to examine bilateral trading patterns. Performance can be evaluated by measuring our worldwide share of markets and by assessing the U.S. share relative to specific countries or regions.

These are all legitimate facets of the concept of U.S. industrial competitiveness in an increasingly international arena. It is therefore not surprising that a wide range of answers have been offered to the simple question: "Is the U.S. competitive?" But careful research does reveal that the U.S. is clearly less competitive today by any reasonable definition.

How Can Competitiveness Be Measured?

As a point of departure, it is probably easiest to ask: how is U.S. industry on the whole doing today relative to the rest of the world? The data requirements arguably then begin with two basic indicators: (1) the U.S. share of the global market for industrial goods; and (2) the output per employee generated by our industries compared to similar measurements for principal competitors. A dynamic dimension can be added by evaluating these same concepts over time. The micro aspect can be substituted for the macro dimension by examining these measures on an industry-by-industry basis. Bilateral performance can be substituted for global performance by comparing the U.S. to selected countries.

An analogy from the world of professional sports may clarify the definition of industrial competitiveness. In professional baseball, the New York Yankees have a tradition of remarkable strength and they are a team other teams love to beat due to their past domination. This team's "macro" record against all competition was outstanding for decades. More games were won than lost by a large margin in total and against each individual ("micro") team. Of the 81 World Series Championships since 1903, the Yankees have participated in a remarkable 33 and won 22. Moreover, when outstanding players were designated such as in the All Star games, the Yankees were disproportionately represented.

Several factors helped create the Yankees' position: a large local market, a good farm club system, aggressive management. (Some parallels to American international trading strength may be apparent.) Today, although the Yankees still consistently win more games than they lose, so do several other very prominant teams. Although their players are among the most highly paid in the country and in the world, they do not win the pennant as frequently. Clearly, they are "less competitive."

What factors led to the dilution of the Yankee's strength? Many other teams simply copied the team's techniques. They observed that a farm club was important, that good scouting was a prerequisite; perhaps the training camp routines were superior or the coaching strategies gave an advantage. The institution of a baseball draft, in which success penalized you in the future, must have also been an ingredient. By observing, copying, and adapting the elements of the Yankees' success, other teams have achieved parity and occasional superiority. The "rules of the game" accepted by the Yankees for the draft, for the distribution of television revenues, and for other aspects neutralized some of the original advantages they enjoyed.

This simplified view of a sports team can help us understand the current status of American competitiveness. In the years following World War II, the United States developed a dominant share of world trade. We beat individual countries in almost every industry in which we chose to compete. We did this on the basis of a well-educated population, abundant natural resources, a commitment to free enterprise and innovation, and, particularly during the 1960s, a very strong and stable domestic economy. In contrast, Europe and Japan had to recover from the war and the less developed countries had no capability to absorb new technology.

To offset our advantages, the trade "rules of the game" that the U.S. accepted during the postwar period gave other nations exceptional opportunities. First, we encouraged them to learn our technology in our schools and factories, to use our technology under generous (and occasionally pirated) licensing terms, and to compete with us internationally while protecting their home markets. We opened our universities, plants and markets, and did not demand fully reciprocal treatment. Second, the dollar was first fixed at a very high exchange rate and then, after the dollar had been allowed to float, we adopted monetary and fiscal policies which, by moving in opposite directions from one another and from those of our trading partners, produced a dramatically overvalued condition. We accepted their initial handicaps because they were our allies; we valued their income growth as an end in itself and as a market for our exports. (This might be similar to the Yankees thinking that they needed teams of like stature in order to be sufficient competition to sustain fan interest.) Today, we need to ask our mature trading partners for full reciprocity on access to markets and technology and we need to bring our monetary and fiscal policies into alignment with the rest of the industrial world.

What Do Measurements of U.S. Competitiveness Reveal?

The first message from the data is that we are no longer dominant in global markets. Market share has fallen to near parity with Germany and Japan, countries with gross national products only one-quarter to one-third the size of the United States. In the competition for global sales, the U.S. share* of adjusted total exports by major industrial nations fell from 28% in 1960 to 20% in 1972; the U.S. share has oscillated about 20% since then, rising when the exchange value of the dollar weakens and falling when it strengthens. The European Economic Community has done no better, with its share declining from 48% to 42% from 1960 to 1972 and to 38% in 1983. The clear gainer among the industrial nations has been Japan, whose share has risen from 5% in 1960 to 10% in 1970 and then 13% in 1983 (Exhibit 1).

This pattern of near parity among the U.S., Germany, and Japan is reinforced by competitive trends in a narrower market: imports by OECD nations. In 1960, the U.S. supplied 18% of all goods imported by OECD nations from anywhere in the world; a decline to 15% in 1972 was followed by a further decline to 13% in 1977, and then a slight recovery to 14% since 1980 as falling real oil prices cut the OPEC share. If OECD imports are further narrowed to only those bought from another OECD member, the U.S. share declines sharply from 26% to 20% during the 1960 to 1972 period (Exhibit 2). Changes in the share since then reflect exchange rate movements. Japan is again a clear winner (Exhibit 3) and the EC a decisive loser (Exhibit 4). Within the EC, gains and losses by Germany (Exhibit 5) and the U.K. (Exhibit 6) clearly reflect currency movements and oil price changes.

*Market shares are calculated as the ratio of export sales by a specific country or group relative to global exports by all OECD nations excluding exports to the designated country or group whose share is under evaluation.

Exhibit 1
Selected Shares of OECD Exports

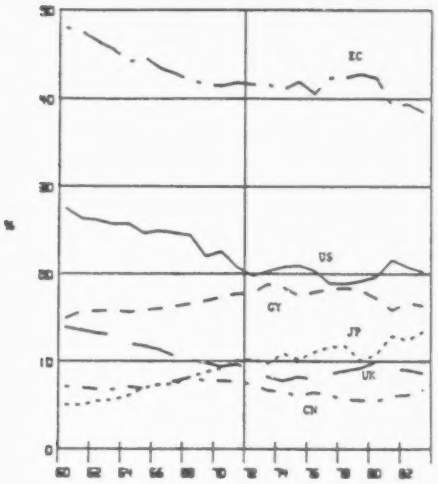


Exhibit 2
U.S. Market Share of OECD Imports

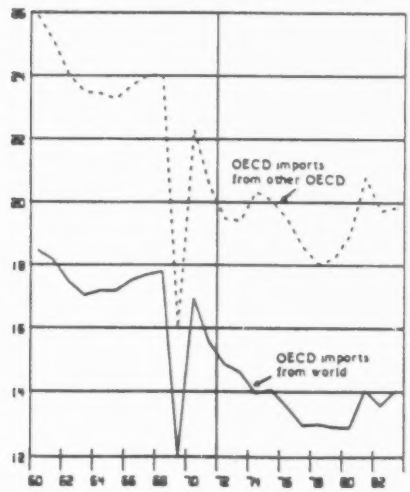


Exhibit 3
Japan Market Share of OECD Imports

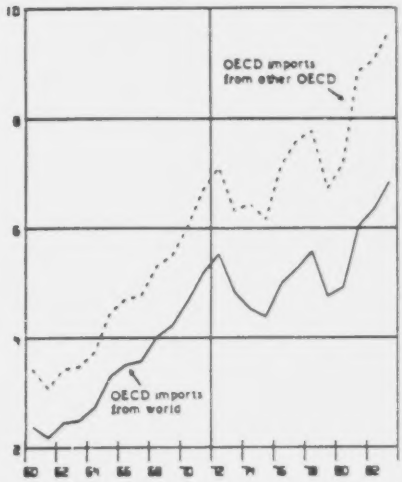


Exhibit 4
EC Market Share of OECD Imports

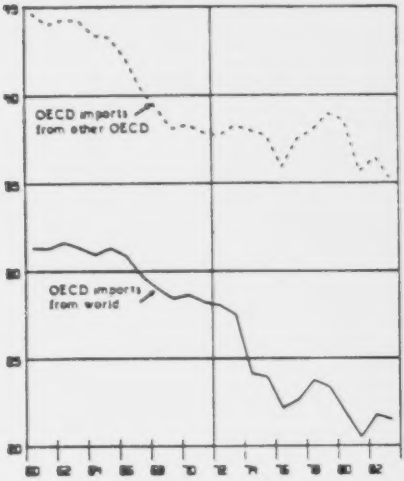


Exhibit 5
German Market Share of OECD Imports

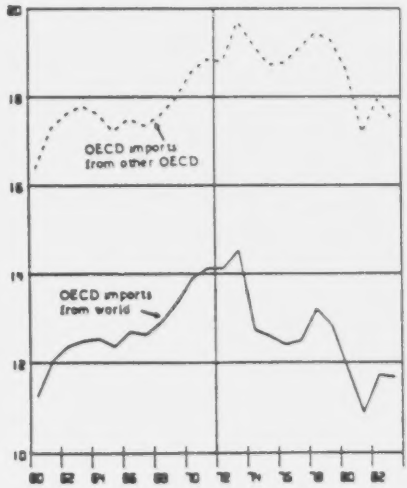
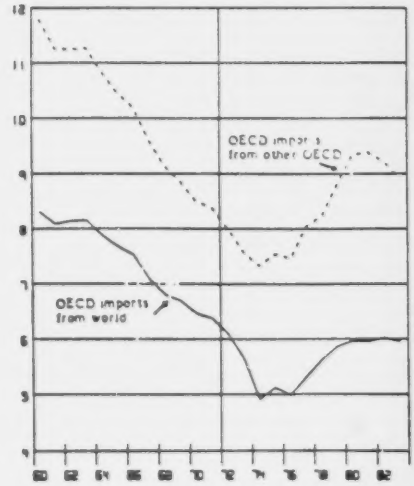


Exhibit 6
U.K. Market Share of OECD Imports



A second aspect of the declining U.S. competitive position is that U.S. exports have to a great extent become "commodities" on the world market. Industries tied to natural resources—agricultural products (food and tobacco), coal, lumber and wood, natural gas, paper—have faired relatively well (Exhibits 7, 8 and 9). We possess productive land and many mineral resources in relative abundance and sell them at world prices. But our manufactured goods have also tended to become commodities in the sense that they must be increasingly sold on the basis of price alone, rather than on the basis of distinctive quality or technical superiority. Even in our own domestic market, a remarkable image change has occurred vis-a-vis Japanese goods: the American consumer frequently associates "made in Japan" with sophistication in engineering and finish, and "made in America" with mass market quality.

The Europeans and Japanese have spent the past 40 years investing in new plant and equipment at a rate substantially higher than the U.S., creating productive capacity that rivals ours in scale and quality of output (Exhibit 10). The technology embodied in the fixed capital is often ours; the managerial and academic skills are often borrowed and transformed versions of ours. It is not surprising that their sales efforts have met with equal success.

The parallel between the U.S. and the Yankees also extends to the performance and pay of the employees, and this is the third conclusion to emerge from the data relevant to U.S. industrial competitiveness: although the average productivity of American workers has continued to rise, productivity in the rest of the world has nearly caught up by growing much more rapidly. Equally important, at current exchange rates, we Americans are as overpaid relative to our competitors as the press image of the Yankees would suggest they are relative to theirs.

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Exhibit 7
Constant Export and Import Share Production
(Percent, 1965 to 1981)

	Trend Production Growth			Loss(-) or Gain(+) In Output Level Due to Changing Trade Shares
	Actual	Constant Share	Difference	1981
Total Manufacturing	3.2	3.4	0.2	-4.1
Food and Products	3.2	3.0	-0.2	2.5
Tobacco Manufactures	1.5	1.0	-0.5	7.5
Textile Mill Products	2.5	2.7	0.1	-4.3
Apparel	2.0	2.8	0.7	-12.2
Lumber and Wood Products	1.8	1.7	-0.1	1.7
Furniture and Fixtures	3.3	3.5	0.2	-3.5
Paper and Products	3.0	3.0	-0.1	1.1
Printing and Publishing	2.7	2.8	0.1	-1.4
Chemicals	5.9	5.8	-0.1	1.4
Petroleum Products	2.6	3.7	1.1	-15.1
Rubber and Plastics	7.6	7.8	0.2	-3.6
Leather Products	-2.6	-0.7	2.0	-33.1
Stone, Clay, and Glass	3.2	3.3	0.1	-2.0
Primary Metals	0.5	0.9	0.4	-8.7
Steel Mill Products	0.0	0.5	0.6	-11.0
Fabricated Metals	2.7	2.9	0.2	-2.6
Nonelectrical Machinery	4.1	3.9	-0.2	1.7
Electrical Machinery	4.4	5.2	0.8	-20.5
Transportation Equipment	1.6	1.8	0.2	-4.1
Motor Vehicles and Parts	1.9	2.3	0.4	-7.4
Instruments	4.6	4.8	0.2	-3.1
Miscellaneous Manufacturing	3.4	4.4	1.0	-17.7

Source: The DRI Report on U.S. Manufacturing Industries, O.Eckstein et al, McGraw-Hill, Inc., (1984).

Exhibit 8
U.S. Merchandise Exports by Product
(Billions of dollars, free alongside ship)

	Level				Percent Change		
	1981	1982	1983	1984*	1982	1983	1984*
Total Exports	233.74	212.27	200.54	216.69	-9.2	-5.5	8.6
Industrial Supplies	67.74	61.73	56.66	61.43	-8.9	-8.2	8.8
Chemicals	17.96	16.96	16.40	18.93	-5.6	-3.3	15.8
Plastics, Synthetics	3.51	3.35	3.42	3.72	-4.6	2.1	9.1
Fertilizers	3.92	3.52	3.33	4.19	-10.2	-5.4	27.0
Petroleum	3.77	6.22	5.00	4.33	65.0	-19.6	-15.3
Coal	6.02	6.08	4.12	4.41	1.0	-32.2	5.3
Paper, Pulp	4.97	4.34	4.26	4.61	-12.7	-1.8	9.2
Lumber	2.64	2.53	2.58	2.49	-4.2	2.0	-3.9
Iron, Steel	5.48	4.22	3.55	3.90	-23.0	-15.9	10.5
Textile Fibers, Fabrics	3.83	2.80	2.34	2.49	-26.9	-16.4	6.4
Cotton	2.28	1.98	1.83	2.44	-13.2	-7.6	41.0
Precious Metals	3.76	1.52	2.06	2.45	-59.6	35.5	12.9
Advanced Metal Products	2.39	1.97	1.78	1.83	-17.6	-9.6	2.2
Aluminum	1.64	1.30	1.39	1.40	-20.7	6.9	3.7
Capital Goods	80.17	72.70	67.25	71.78	-9.3	-7.5	7.1
Computers, Parts	8.84	9.32	11.01	13.92	5.4	18.1	28.1
Scientific, Business Equipment	7.49	7.05	6.45	6.67	-5.9	-8.5	3.6
Civilian Aircraft, Parts	13.47	9.71	10.69	9.38	-27.9	10.1	-11.5
Broadcasting, Communications	5.74	5.97	6.63	7.85	4.0	11.1	20.0
Telephonic, Other Electrical	5.06	4.92	4.90	5.58	-2.8	-0.4	15.3
Construction Machinery	7.08	4.88	6.45	6.45	-31.1	32.2	-1.8
Drilling Equipment	4.54	5.43	3.14	2.77	19.6	-42.2	-15.3
Specialized Industrial Machinery	3.67	3.29	2.77	3.35	-10.4	-15.8	21.4
Power-Generating Machinery	2.93	2.85	2.35	2.21	-2.7	-17.5	-3.5
Agricultural Machinery	2.23	1.80	1.47	1.70	-19.3	-18.3	13.3
Machine Tools	2.09	1.59	1.15	1.23	-23.9	-27.7	7.9
Automotive Vehicles, Parts	17.99	15.67	16.82	20.95	-12.9	7.3	25.7
Passenger Cars	4.01	2.93	4.25	4.86	-26.9	45.1	14.1
Trucks, Buses	3.31	2.47	1.98	2.47	-25.4	-19.8	24.1
Parts, Engines	10.67	10.27	10.62	13.27	-3.7	3.4	28.5
Consumer Goods	15.80	14.31	13.44	13.44	-9.4	-6.1	-0.5
Durables, except Autos	7.50	6.30	5.74	5.82	-16.0	-8.9	-5.0
Appliances	1.83	1.51	1.25	1.38	-17.5	-17.2	-18.8
Sporting Goods	1.19	1.11	1.03	0.83	-6.7	-7.2	-21.0
Nondurables	8.30	8.00	7.70	7.92	-3.6	-3.8	2.9
Drugs, Medicine	2.31	2.43	2.64	2.79	5.2	8.6	6.1
Textile Products	1.54	1.25	1.10	1.15	-18.8	-12.0	3.6
Foods, Feeds, Beverages	37.89	31.34	30.94	30.90	-17.3	-1.3	2.1
Feed Grains	9.47	6.50	7.33	7.84	-31.4	12.8	14.3
Wheat, Flour	8.15	6.92	6.56	6.92	-15.1	-5.2	4.8
Soybeans	6.19	6.22	5.91	5.09	0.5	-5.0	-10.5
Military-Type Goods	4.18	6.52	5.84	4.70	56.0	-10.4	-23.3
Reexports	4.78	5.12	4.57	5.73	7.1	-10.7	26.8
Other	5.19	5.19	4.90	7.86	0.0	-5.6	59.1

*First ten months of 1984; percent change from first ten months of 1983

Exhibit 9
U.S. Merchandise Imports by Product
(Billions of dollars, customs value basis)

	Level				Percent Change		
	1981	1982	1983	1984*	1982	1983	1984*
Total	261.30	243.95	258.05	328.88	-6.6	5.8	28.6
Industrial Supplies	134.63	112.04	106.96	124.74	-16.8	-4.5	16.4
Petroleum	77.11	60.85	53.59	57.74	-21.1	-11.9	7.2
Natural Gas	4.12	4.39	4.18	3.41	6.6	-4.8	-19.6
Iron, Steel	13.16	11.40	8.11	11.96	-13.4	-28.9	54.1
Precious Metals	4.13	3.49	4.95	5.28	-15.5	41.8	-2.2
Aluminum	1.38	1.33	1.64	2.60	-3.6	23.3	59.5
Paper, Pulp	5.60	5.27	5.58	7.23	-5.9	5.9	32.2
Lumber	2.73	2.26	3.45	4.29	-17.2	52.7	10.3
Industrial Chemicals	4.16	4.07	5.04	6.32	-2.2	23.8	25.9
Fertilizers	1.80	1.61	1.69	2.10	-10.6	5.0	25.7
Textile Fibers, Fabrics	2.04	2.27	2.60	3.63	11.3	14.5	41.2
Capital Goods	34.49	35.35	40.85	60.55	2.5	15.6	51.0
Electrical Machinery	9.88	10.55	12.92	19.03	6.8	22.5	52.6
Computers, Business Machines	4.74	6.17	8.91	14.03	30.2	44.4	62.6
Industrial Machinery	5.76	5.53	5.12	7.78	-4.0	-7.4	52.0
Construction, Specialized Machinery	3.37	2.99	3.66	5.96	-11.3	22.4	66.0
Civilian Aircraft, Parts	3.75	3.43	2.94	3.98	-8.5	-14.3	33.6
Machine Tools	1.99	1.90	1.50	2.08	-4.5	-21.1	33.8
Agricultural Machinery	1.75	1.46	1.33	1.99	-16.6	-8.9	40.1
Scientific Equipment	0.94	1.08	1.34	1.71	14.9	24.1	26.7
Automotive Vehicles, Parts	29.74	33.25	40.83	53.86	11.8	22.8	37.3
Passenger Cars	17.77	20.28	23.57	29.84	14.1	16.2	31.3
Parts	7.12	7.76	11.34	16.06	9.0	46.1	48.2
Trucks, Buses	4.84	5.21	5.92	7.95	7.6	13.6	40.7
Consumer Goods	38.66	39.69	44.93	60.86	2.7	13.2	36.2
Durables, except Autos	23.53	23.25	25.54	33.98	-1.2	9.8	34.9
Household Appliances	5.71	5.58	6.77	9.88	-2.3	21.3	54.1
Jewelry, Art, Musical	2.49	2.81	3.15	4.15	12.9	12.1	34.7
Sporting Goods	2.04	1.69	1.59	3.21	-17.2	-5.9	34.3
Bicycles, Motorcycles, Boats	1.54	1.85	1.92	1.92	20.1	3.8	20.0
Metalwares, Garden Tools	1.41	1.39	1.56	2.47	-1.4	12.2	32.8
Photographic, Optical Goods	2.20	2.72	2.43	1.97	23.6	-10.7	27.9
Wood Furniture, Skis	1.12	1.15	1.43	1.89	2.7	24.3	36.0
Nondurables	15.14	16.44	19.39	26.87	8.6	17.9	37.7
Apparel, Textile Products	7.77	8.41	9.86	14.15	8.2	17.2	41.2
Leather Goods	2.32	2.74	3.24	4.54	18.1	18.2	39.7
Foods, Feeds, Beverages	18.11	17.12	18.19	21.18	-5.5	6.3	16.8
Fish	2.95	3.15	3.59	3.68	6.8	14.0	4.8
Vegetables, Fruit	2.50	2.83	2.93	3.11	13.2	3.5	17.8
Coffee	2.62	2.72	2.59	3.21	3.8	-4.8	23.9
Meat, Cattle	2.17	2.33	2.35	2.40	7.4	0.9	-3.6
All Other	5.67	6.51	6.28	7.70	14.8	-3.5	21.1

*First ten months of 1984; percent change from first ten months of 1983

Compared to the U.S., Japanese real output per worker in manufacturing has steadily risen from 20% to nearly 85% of the U.S. worker's productivity (Exhibit 11). The average Japanese worker's pay in the manufacturing industry has risen from 10% of his U.S. peer's to approximately 50% (Exhibit 12) due to more rapid nominal pay increases and exchange rate movements. Putting these wage and productivity numbers together, the total compensation per unit of output for a Japanese worker was less than half of his U.S. counterpart in 1960 and still only 60% in 1971; although rapid Japanese inflation after the first oil price shock plus the depreciation of the dollar brought parity very temporarily in 1978, today's strong dollar has pushed Japanese pay relative to productivity back down to 60% (Exhibit 13). During the past decade, the only nations with higher pay relative to output for a prolonged period have been the U.K. and Germany; consequently, these two countries have also been experiencing deteriorating trade shares in manufactured goods.

The exchange rate has a pervasive influence on market shares and on the determination of relative pay levels. The sharp appreciation of the dollar since mid-1980 (approximately 50% against a basket of major currencies) has been the major factor that has pushed the United States into a serious foreign trade deficit. To be sure, a stronger economic recovery in the U.S. than abroad has also contributed to our trade deficit. Careful analysis reveals, however, that our net export position is approximately $61 billion worse in 1985 than it would have been had the dollar been held at its 1980 level (Exhibit 14).

A strong dollar is good if it is justified by the productivity of the nation. A currency with a relatively high value allows the United States to import goods more cheaply and provides a direct benefit to the consumer. But if the dollar is priced so high that

Exhibit 10
Real Manufacturing Investment as a
Share of GNP, Japan and the United States
(Percent

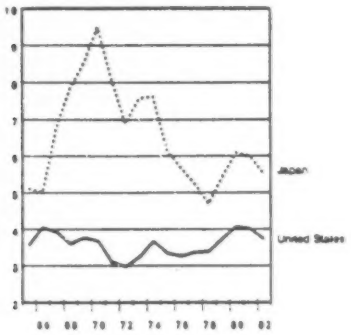

Exhibit 11
Output per Hour in Manufacturing:
Multiples of the U.S. Level

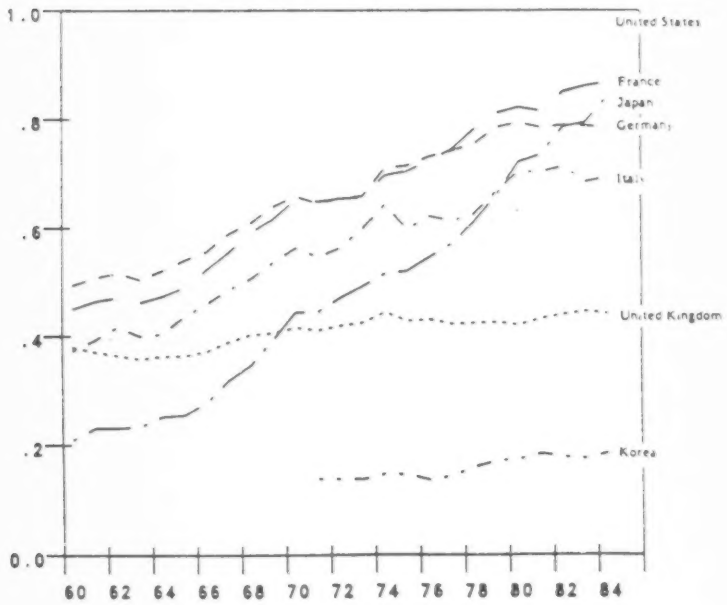

Exhibit 12
Average Hourly Compensation in Manufacturing:
Multiples of the U.S. Level

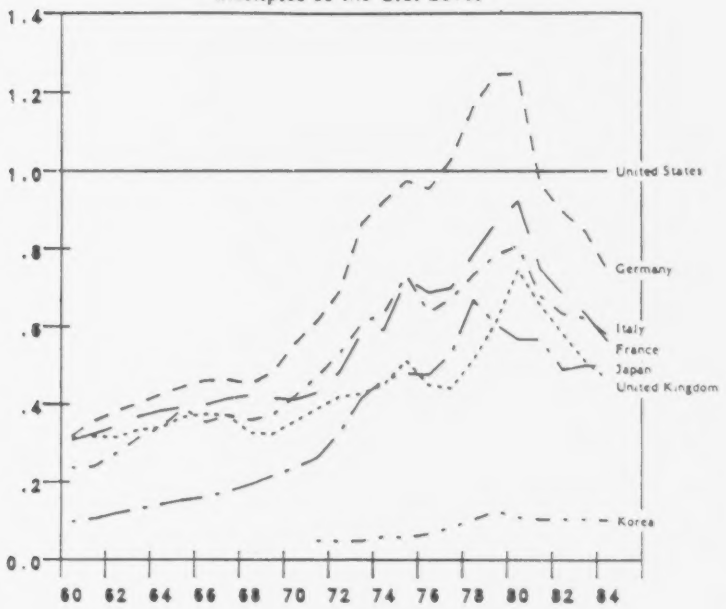

Exhibit 13
Unit Labor Cost in Manufacturing:
Multiples of the U.S. Level

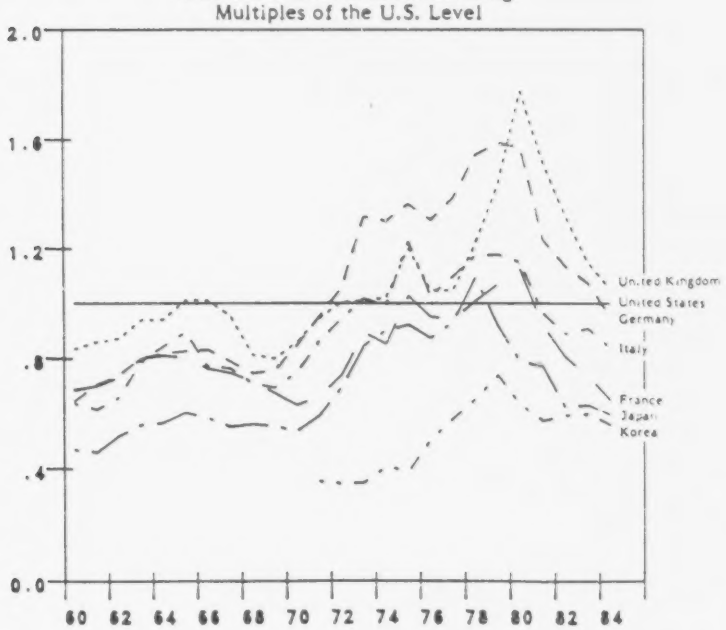

Exhibit 14
The Macroeconomic Impact of the Dollar's Exchange Rate
(Comparison of the Weak Dollar case
with History and the Strong Dollar projection)

	1981	1982	1983	1984	1985	1986	1990
				(Percent Difference)			
Dollar Exchange Rate	-9.2	-17.6	-21.3	-26.9	-29.8	-30.7	-35.3
Real Dollar Exchange Rate	-8.4	-15.1	-17.5	-21.9	-23.5	-23.6	-23.5
Real GNP	0.1	1.0	2.0	3.2	4.2	5.0	6.3
Consumption	0.0	0.0	0.1	0.3	0.5	0.8	1.3
Business Investment	0.0	0.0	1.0	2.7	5.1	7.8	14.0
Residential Investment	0.1	0.1	-0.8	-1.4	-1.6	-1.6	-1.9
Federal Government	0.0	0.0	0.0	0.0	0.0	0.0	0.0
State and Local Government	0.0	0.1	0.5	1.1	1.9	2.5	3.8
Exports	0.9	5.8	10.4	12.8	15.4	16.2	16.3
Imports	-0.5	-4.5	-9.5	-13.0	-14.3	-14.7	-12.6
Consumer Price Index	0.3	1.2	2.1	3.2	4.6	5.9	12.4
Wholesale Industrial Prices	0.8	3.0	4.7	6.6	8.5	9.6	17.0
Merchandise Import Prices	5.5	14.8	20.5	25.8	31.6	33.2	41.0
Merchandise Export Prices	0.4	2.3	4.5	6.8	9.4	11.3	21.0
Real Disposable Income	-0.1	0.0	0.4	0.9	1.3	1.8	3.1
Real Profits after Tax	-0.2	3.9	8.8	13.8	18.7	20.8	9.7
Industrial Production	0.4	2.6	4.7	7.4	9.4	10.5	11.8
				(Difference, Units)			
Net Exports ($Bil.)	-10.1	3.9	28.1	47.5	60.6	73.5	90.2
Unemployment Rate (%)	0.0	-0.4	-0.8	-1.1	-1.5	-1.8	-1.8
Employment (Millions)	0.0	0.4	0.9	1.4	2.0	2.3	2.4
High-Grade Corp. Bond Rate (%)	0.0	0.3	0.6	1.1	1.4	1.7	2.2
Car Sales (Millions)	0.0	0.1	0.1	0.3	0.4	0.5	0.4
Federal Budget Surplus ($Bil.)	0.4	11.4	25.3	47.6	67.1	85.6	134.3

Exhibit 15
The Dollar's Impact on Manufacturing Production
(Percent difference in level, comparing the Weak Dollar case with the Strong Dollar case)

	1981	1982	1983	1984	1985	1986	1990
Manufacturing Production	0.4	2.6	4.7	7.4	9.4	10.5	11.8
Nondurables:	0.3	1.8	3.5	5.9	7.3	8.0	9.1
Foods	0.1	0.7	1.2	1.5	1.8	2.0	2.2
Textile Mill Products	0.5	3.3	6.3	13.5	16.6	17.8	19.5
Apparel Products	0.5	3.1	5.8	10.7	11.9	12.5	13.4
Paper and Products	0.4	2.0	3.4	4.6	5.8	6.5	7.9
Printing and Publishing	0.0	0.1	0.5	1.4	2.0	2.5	3.6
Chemicals and Products	0.6	3.1	5.5	8.6	10.6	11.6	13.2
Petroleum Products	-0.1	-0.4	-0.3	0.1	0.6	0.9	2.2
Rubber and Plastics	0.2	2.1	4.3	8.1	10.2	11.3	12.7
Leather and Products	0.8	4.4	8.1	19.0	21.1	21.9	27.2
Durables:	0.6	3.8	6.7	9.9	12.8	14.3	15.7
Lumber and Products	0.4	2.2	3.3	4.5	6.9	8.2	11.6
Furniture and Fixtures	0.0	0.4	1.0	2.7	3.6	4.7	7.4
Clay, Glass and Stone	0.2	1.4	2.6	4.5	5.6	8.3	9.?
Primary Metals	0.5	3.8	6.6	10.5	13.8	15.2	15.6
Fabricated Metal Products	0.3	2.3	4.5	6.8	9.0	10.7	13.0
Nonelectrical Machinery	0.8	5.0	9.0	11.5	15.1	17.5	21.3
Electrical Machinery	0.9	5.6	9.7	13.9	17.4	18.8	19.2
Transportation Equipment	0.5	3.2	5.5	8.9	11.1	12.2	10.6
Instruments	0.7	4.4	8.6	13.3	17.3	19.8	23.4
Miscellaneous Manufactures	0.4	4.0	8.1	15.7	19.0	21.5	26.4

Exhibit 16
The Dollar's Impact on Manufacturing Employment
(Difference in level, comparing the Weak Dollar case with the Strong Dollar case, thousands of dollars)

	1981	1982	1983	1984	1985	1986	1990
Manufacturing Employment	45	365	709	1,108	1,453	1,676	1,803
Nondurables:	13	104	201	325	416	469	483
Food and Products	2	16	27	31	33	37	32
Textile Mill Products	2	15	30	58	78	85	85
Apparel and Products	3	22	47	84	112	126	128
Paper and Products	1	9	15	18	21	23	24
Printing and Publishing	1	8	12	14	14	18	18
Chemicals and Products	2	17	34	51	66	79	92
Petroleum and Products	0	1	1	0	0	0	-1
Rubber and Plastics	1	11	23	45	63	72	81
Leather and Products	1	6	11	21	28	26	25
Durables:	32	261	508	783	1,037	1,207	1,319
Lumber and Products	2	12	23	31	40	52	68
Furniture and Fixtures	0	3	5	11	17	22	36
Stone, Clay and Glass	1	7	13	20	29	37	42
Primary Metal Industries	3	18	32	51	69	79	81
Fabricated Metal Products	4	26	52	85	120	146	184
Machinery Except Electrical	8	72	139	194	250	297	337
Electrical Machinery	7	67	129	193	241	259	237
Transportation Equipment	6	36	67	114	157	176	159
Instruments	1	11	24	38	55	72	103
Miscellaneous Manufacturing	1	11	24	45	59	66	73

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producers cannot manufacture comparable goods at comparable cost, then jobs will be lost. Exhibits 15-16 make it very clear that this has indeed been the case during the first half of the 1980s: the number of manufacturing jobs is over 1.4 million lower today than it could have been if the dollar had maintained the reasonable values of 1980 rather than appreciated to the exceptional levels we see today.

The influence of the dollar on the economy is not a new phenomenon. The exhibits on trade shares clearly reveal the impact of a very strong dollar during the 1960s. Similarly, the swings in the U.S. share during the 1970s very closely correspond to changes in the value of the currency: after the dollar declined against the yen and Deutche mark in 1977 and 1978, U.S. export performance improved in 1978 and 1979. There is a clear and logical correlation here.

The fourth conclusion from data analysis is that, relative to Japan, the U.S. real post-tax cost of funds has typically been substantially higher: on average for the past decade, the U.S. cost has been 5.1% and the Japanese only 0.1%. This cost of financial capital differential between U.S. and Japanese corporations is due to the following factors.

1. In Japan, the return to investors on 75% of the capital employed is made tax deductible by being treated as debt; the corresponding figure for U.S. corporations is on average only 25%. It should be pointed out that by U.S. rules a significant part of corporate debt in Japan would be classified as equity, so that the returns to stockholders would be classified as dividends (rather than interest payments) and therefore would not be deductible.

2. Income tax rules in Japan alleviate the double taxation of dividend income by

i. taxing distributed profits more lightly than undistributed profits at the corporate level.

ii. allowing individuals a dividend tax credit, generally at the rate of 10% of their dividend income.

3. Investors' capital gains in Japan are not taxed.

4. Real interest rates available to Japanese corporations have averaged much lower than those available to U.S. corporations.

Ths substantial Japanese cost of funds advantage has meant that despite more generous depreciation allowances and the investment tax credit in the U.S., Japan has generally enjoy ⁴ a considerably lower cost of capital services for fixed capital equipment and structures. The Japanese advantage in the cost of capital services for land, inventories, and research and development has been even greater.

The current cost of labor and capital in the U.S. are inconsistent with the current strength of the dollar in foreign exchange markets. Only energy costs are relatively low in the U.S., but this one area of advantage represents the smallest share of total cost. A careful compilation of all three cost categories--labor, capital and energy--reveals that Japanese total manufacturing costs in 1984 were only 71% of those in the U.S. (Exhibit 17). This implies that the exchange rate would need to have been approximately 168 yen per dollar rather than 237 in order to equalize long-term manufacturing costs between the two countries. This margin between actual exchange rates and the manufacturing cost-equilibration rate has provided the Japanese with high profit margins in an expanding market. These profits will finance future investment and even greater competitive pressure.

U.S. and International Manufacturing Costs

Exhibit 17
Japanese Manufacturing Costs
as a Percent of U.S. Costs

	1965	1970	1975	1980	1984
Labor	60	54	92	79	60
Capital	95	64	51	90	96
Energy	184	168	192	243	188
Composite	72	60	86	88	71

Exhibit 17a
Foreign Labor Cost Components
in Relation to U.S. Producers:
(U.S. = 100)

	1970	1975	1980	1981	1982	1983	1984
AVERAGE HOURLY COMPENSATION							
France	41	72	92	75	68	63	56
Germany	56	97	125	97	90	85	75
Italy	42	73	81	68	63	62	58
Japan	24	48	57	57	49	50	50
Korea		6	11	10	10	10	10
United Kingdom	36	51	75	65	58	51	46
United States	100	100	100	100	100	100	100
OUTPUT PER HOUR							
France	65	70	82	81	85	86	87
Germany	66	71	79	78	79	79	78
Italy	56	60	70	70	71	68	69
Japan	44	52	72	74	79	79	84
Korea		15	17	18	18	17	18
United Kingdom	41	43	42	43	44	45	44
United States	100	100	100	100	100	100	100
UNIT LABOR COSTS							
France	63	103	112	92	80	74	65
Germany	85	136	157	123	114	107	95
Italy	75	123	115	96	89	91	84
Japan	53	92	79	77	62	63	60
Korea		39	63	57	59	60	56
United Kingdom	86	120	177	151	132	115	105
United States	100	100	100	100	100	100	100

Exhibit 17b
Equipment Cost Components

	1970	1975	1980	1981	1982	1983	1984
RELATIVE EQUIPMENT PRICE (US=100) - US DOLLARS							
Germany	97	138	163	128	122	119	105
Japan	79	94	94	93	82	84	83
United Kingdom	102	124	187	163	148	134	115
United States	100	100	100	100	100	100	100
RELATIVE STRUCTURES PRICE (US=100) - US DOLLARS							
Germany	182	211	233	174	156	154	141
Japan	93	132	150	144	126	137	139
United Kingdom	173	225	282	237	189	170	153
United States	100	100	100	100	100	100	100
REAL COST OF FUNDS (PERCENT)							
Germany	2.68	1.65	2.81	3.10	2.68	2.03	2.23
Japan	1.45	-3.88	1.65	1.74	2.01	2.35	2.60
United Kingdom	4.98	5.46	5.01	4.50	4.39	4.14	4.73
United States	4.64	4.43	5.48	5.53	5.88	4.88	5.48
RENTAL PRICE OF EQUIPMENT (US=100) - US DOLLARS							
Germany	92	138	160	133	123	118	102
Japan	64	61	86	89	81	88	86
United Kingdom	75	105	148	132	121	114	104
United States	100	100	100	100	100	100	100
RENTAL PRICE OF STRUCTURES (US=100) - US DOLLARS							
Germany	168	173	205	167	144	145	126
Japan	61	31	96	98	90	112	111
United Kingdom	133	181	204	143	114	111	105
United States	100	100	100	100	100	100	100
RENTAL PRICE OF FIXED CAPITAL (US=100) - US DOLLARS							
Germany	112	150	178	147	132	129	112
Japan	64	51	90	92	85	97	96
United Kingdom	91	131	170	136	118	113	104
United States	100	100	100	100	100	100	100

Exhibit 17c
Foreign Energy Costs in Relation to U.S.
(U.S. = 100)

	1970	1975	1980	1981	1982	1983
France	157	160	196	158	134	122
Germany	177	184	182	147	132	122
Italy	148	141	185	149	133	123
Japan	168	192	243	232	194	188
United Kingdom	155	146	169	142	120	104
United States	100	100	100	100	100	100

Exhibit 17d
Foreign Total Costs in Relation to U.S.
(U.S. = 100)

	1970	1975	1980	1981	1982	1983	1984
Germany	95	142	163	129	118	113	100
Japan	60	86	88	87	72	75	71
United Kingdom	91	124	175	147	128	114	105
United States	100	100	100	100	100	100	100

In summary, the measurements reveal that the U.S. is still a major competitor, but not nearly as strong as in earlier years and in a continually weakening position. We have not lost the ability to compete. We have, however, accepted lopsided "rules of the game" in international trade, and we have selected macroeconomic policies leading to extraordinarily high interest rates and an over-valued exchange rate. Compounding these problems, the heavy taxation of equity capital has combined with high nominal interest rates to produce a post-tax cost of funds much higher than that of our principal rival, Japan. This high cost has a doubly negative impact on U.S. competitiveness: the cost of current production is higher and new investment is lower. Suboptimal investment diminishes national productivity and therefore real living standards; it also inhibits the product development necessary to sell U.S. goods as leading-edge products demanding a premium on world markets, rather than as commodities facing intense price competition.

HOW CAN AND SHOULD POLICY BE ADJUSTED TO ENHANCE U.S. COMPETITIVENESS?

Monetary and fiscal policies combined with general principles of trade policy set the competitive tone for the U.S. economy. The increasing severity of the U.S. trade deficit since 1980 is a clear indication that our policy formulation has not caught up with the realities of an open international economy. Every decision that Congress and the Administration make to change spending or taxation has an impact on the U.S. competitive position. The high level of today's federal budget deficit, the high interest rates that correspond to that deficit, and the excessively strong dollar created by those interest rates indicate that Washington policymakers have not sufficiently faced up to the linkage between their actions and the problems faced by American industry competing for global customers.

During the postwar period until 1980, U.S. fiscal policy was largely focused on short-run economic stabilization: taxes were cut and expenditures were increased during recessions in order to stimulate demand. During recoveries, automatic stabilizers such as a progressive, non-indexed income tax expanded revenues more rapidly than national income. Because many expenditures programs were also not indexed to inflation, growth tended to reduce the share of spending in the economy as it raised the tax share (Exhibit 18). Therefore, a reasonable expectation was that federal budgets would converge toward balance during each business cycle recovery and that cyclical deficits would be sufficiently small that the ratio of debt to GNP would decline except in periods of war (Exhibit 19). The financial markets reflected this with fairly stable bond prices, producing a yield only 2.5-3.0% above the expected inflation rate (Exhibit 20).

In addition to these aggregate patterns, certain microeconomic incentives have had persistent roles in fiscal policy, motivated by both cyclical and structural objectives. From a long-term growth perspective, the most important tax features have been the investment incentives provided by such measures as the durable equipment tax credit, various accelerated depreciation provisions, and favorable treatment for residential construction. Although these policies have typically been introduced or expanded as part of a countercyclical stimulus package, they are also explicitly intended to boost long-term capital formation and productivity growth.

Today, the focus and philosophy for fiscal policy is very different: the highest priorities appear to be lower personal tax rates and an accelerated defense program. There is no official plan to reduce the deficit to a traditional size relative to our national income. Currently proposed reductions in nondefense purchases, grants-in-aid to states, and transfer programs are insufficient to balance the budget now or in the foreseeable

Exhibit 18
Federal Fiscal Patterns During Recovery:
Spending and Taxes as a Percent of GNP
(Vertical lines represent recession troughs)

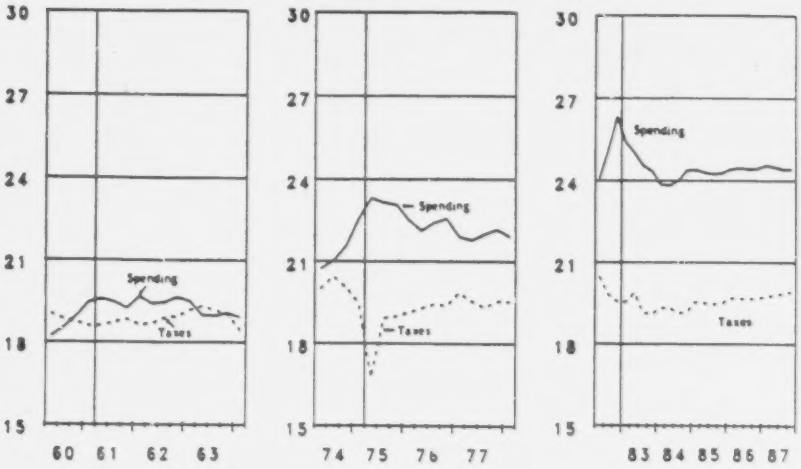


Exhibit 19
Large, Sustained Deficits Will Sharply
Increase the Debt-to-GNP Ratio

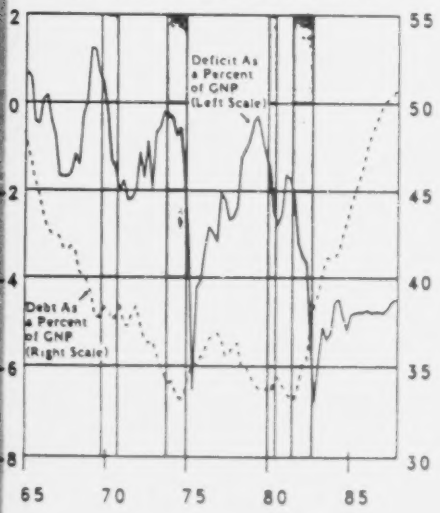
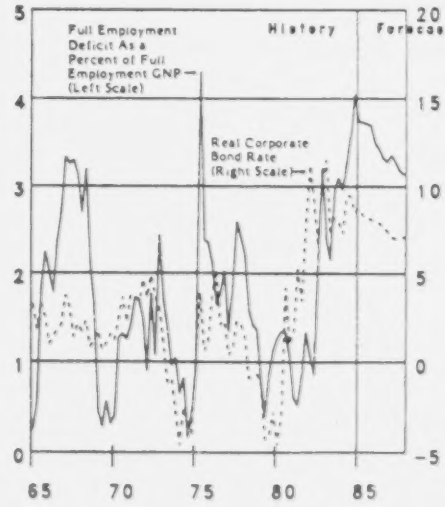


Exhibit 20
Government Borrowing Pressure and Credit Conditions:
The Full-Employment Deficit (Percent of GNP)
and the Bond Rate Minus Prevailing Inflation



future, and the only tax increase that is under consideration is a 30% increase in corporate taxes and the elimination of the investment incentives noted above.

The large federal deficit, current and prospective, is the primary cause of today's high interest rates. Conservative monetary policy is a contributing factor, but its primary influence is on the allocation of the high nominal rates between the level of real (inflation-adjusted) credit costs and on the inflation premium. Moderate, as opposed to stimulative, expansion of the banking system's reserve base has combined with the large current federal deficit to produce an extreme scarcity of short-term funds available to private domestic borrowers, and therefore a large gap between both short- and long-term interest rates and current inflation. The central bank's willingness to pursue such policy consistently has cut domestic inflation by approximately two-thirds since 1979. Since the Fed has now achieved credibility as a determined opponent of inflation, the inflation premium in long-term rates is markedly lower today. Nominal long-term interest rates are not high today because of inflation fears; they are high because the credit market is expected to remain imbalanced given a persistently large federal deficit and thus to continue to produce high real interest rates.

Other things equal, this high real cost of funds has three major detrimental impacts on long-term growth prospects. First, the high hurdle rate required for investment projects implies less capital formation will take place. Second, net foreign investment will finance approximately 40% of the net expansion of the nation's capital stock; the future returns on that stock will therefore accrue abroad, a substantial and growing drain on future national income. Third, the unreasonable strength of the dollar will continue unreasonably to divert the employment and output mix of the nation away from manufacturing, a sector which offers the highest real productivity to the economy.

Exhibit 21
The Rising Trade Gap

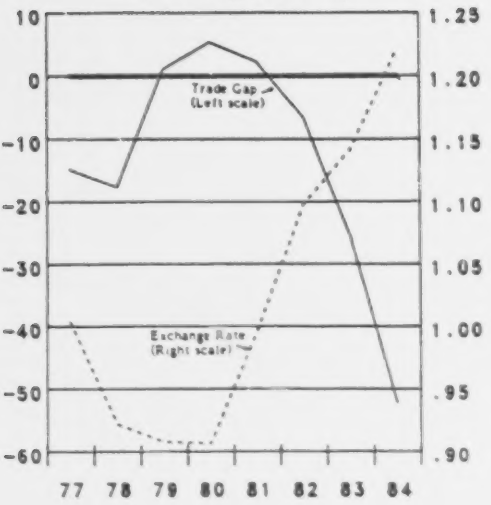


Exhibit 22
The Federal Budget Deficit's Role
in Exchange Rate Movements

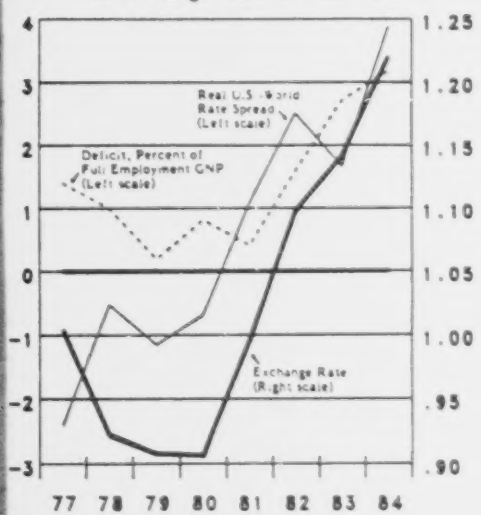
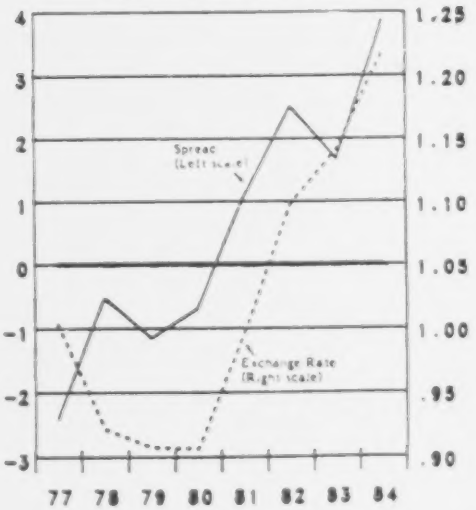


Exhibit 23
Exchange Rate and Real Yield Spread



To most observers, the chain of causes and effects linking federal deficits, interest rates, and the exchange rate are logical: given any state of the national economy, the greater the federal deficit, the stronger the federal government's demand for funds; the greater the demand for funds, the higher the level of interest rates; the higher the level of American interest rates compared to foreign interest rates, the greater the demand for dollar investments. When the dollar is driven up through such financial incentives rather than through fundamentals of strong productivity growth, our exporters suffer and imports gain a greater share of U.S. domestic markets. Exhibits 21-23 should offer convincing illustrations. An econometric decomposition of the factors behind U.S. exchange rate strength during the past seven years clearly indicates that each percentage point increase in U.S. real interest rates relative to foreign rates adds 4-5% to the value of the dollar. In 1984, the U.S. rate differential had moved to 3.0% versus -0.7% in 1980, thus explaining much of the current overvalued state of the dollar. The average 10-year U.S. government bond yield of 12.4% in 1984 implied a real rate of over 9%, three times greater than the postwar norm of approximately 3% (Exhibit 24).

Not All Deficit Cures Would Be Productive

Although the deficit is clearly bad for U.S. competitiveness, some deficit cures would be counterproductive. In particular, any policy that raises the cost of capital may well handicap American industry as much or more than it helps. Recall that the deficit is itself harmful because of its impact on interest rates and U.S. asset accumulation. High interest rates have a doubly negative effect on American competitiveness: they strengthen the dollar in foreign exchange markets and make U.S. goods less competitive; they also reduce American investment, which is absolutely necessary to maintain the quality of our goods and the productivity of our workers. American fiscal and monetary policies must be very carefully adjusted to enhance investment and future growth

Exhibit 24
Persistent Federal Deficits
Imply Scarce Long-Term Funds

	Real Rate*	10-year U.S. Bond Yield	Current Inflation**	Expected Inflation***
1984	9.3	12.4	3.0	3.2
1983	6.1	11.1	2.0	5.0
1982	4.8	13.0	4.5	8.2
1981	3.7	13.9	8.8	10.2
1980	1.9	11.5	11.6	9.5
1955-84	2.6	6.7	4.2	4.1
1980-84	5.2	12.4	6.0	7.2
1975-79	-1.1	8.2	8.9	9.2
1965-74	3.2	6.1	4.0	2.9
1955-64	2.5	3.7	1.2	1.2

*Nominal 10-year bond yield minus expected inflation.
**Trailing year percent change in wholesale prices for industrial commodities except energy.
***Trailing three year percent change in the WPI stated above.

prospects: that is the goal of deficit reduction, not just budget-balancing as an end in itself.

Finally, a broad definition of investment should be used as policies are developed to support U.S. competitiveness: investment is not just machine tools, computers and buildings, but also research, education, job training, and the national infrastructure. Lower post-tax capital costs will encourage all of these, but maintaining certain limited, additional stimuli or focused efforts may also be worthwhile.

The major thrusts of deficit reduction should come through lower growth in the entitlement programs such as Social Security, a reduction in the inflation-indexation of the personal income tax, and a hard-nosed look at the defense budget in areas such as retirement benefits. Reductions in these indicated expenditure and transfer programs and higher personal taxes will increase the national savings and investment pool: for every dollar the deficit is reduced through such steps and hence funds are freed for private investment, only a fraction--five to ten cents--would be cut from private savings due to lower post-tax, post-transfer household income. The net gain in national savings would thus be 90 to 95 cents per dollar of deficit reduction.

U.S. households are small savers by world standards, hence personal consumption and not national saving would be curtailed. Measured on a national income account basis, personal saving is typically 6.5-7.5% of disposable income, indicating very clearly that consumers promptly spend nearly all of any incremental income and cut back expenditures almost dollar for dollar when income growth is reduced.

The Costs of Increasing Business Taxation

In contrast, a net increase in business taxes would tend to reduce capital formation because the corporate sector has a very high propensity to save and invest. The loss would be particularly great if taxes were increased by eliminating high-powered investment incentives such as the equipment and R&D tax credits. According to careful econometric analysis, each dollar of federal corporate tax revenue raised through lower equipment tax credits would cut capital spending by approximately fifty-five cents; each dollar raised through a weaker R&D credit would cut R&D programs by $1.20. Even a lower-powered change, such as an increase in the statutory corporate tax rate, would reduce nonresidential investment by over thirty cents for each dollar of corporate tax revenue gained (Exhibit 25).

The relative sizes of these "bang-for-the-buck" estimates of investment stimulus or loss per dollar change in corporate tax revenue reflect the extent to which each program acts at the margin of investment decision-making, benefitting or restraining new investment rather than also altering the taxation of capital which is already in place. The R&D credit, applicable to only increases in current spending beyond a base-year period, logically has the greatest leverage; the equipment credit, on all new investment, has less potency but is still stronger than changes in the overall rate.

To be sure, there are also efficiency issues which should be considered, and such analysis does reduce the attractiveness of credits which apply to only some forms of investment and not to others. If the current system of tax credits and accelerated depreciation provisions provides a disproportionate benefit to equipment purchases compared to plant expansion, then the nation suffers an efficiency loss through misallocation of the national savings pool in favor of short-lived assets. The bang-for-the-buck analysis suggests that

Exhibit 25
The Leverage of Alternative Tax Stimuli to Investment
(Excluding feedback effects)

	Increased Investment Tax Credit[1]	Lower Statutory Corp. Tax Rate[2]	Enhanced R&D Tax Credit[3]	50% Dividend Deductibility[4]	Full New Issue Dvd. Deduct.[5]
Average Annual Impact ($Billion, Years 1-10)					
Corp. Tax Liability	-47.6	-49.1	-5.5	-34.7	2.4
Nonres. Investment	24.9	15.9	1.3	15.7	1.7
R&D Spending	1.6	0.1	6.8	2.7	0.3
Investment "Bang-for-the-Buck"	0.55	0.32	1.47	0.54	0.83
Productivity Gain ($increase, 10th year)	1.0	0.6	0.4	0.7	0.1
Potential GNP Gain ($ per capita, 10th year, 1984 prices)	112	63	41	79	9

[1]Increase in maximum rate of credit from 10% to 19%, designed to give a static revenue loss of $25 billion initially.
[2]Reduction in statutory federal corporate tax rate from 46% to 33%, also designed to give an initial $25 billion static revenue loss.
[3]Expansion of the 5% R&D tax credit to apply to all spending above a fixed base, rather than above a rolling base as under current law.
[4]Provision allowing deduction of 50% of corporate dividends from taxable corporate income.
[5]Provision allowing full deductibility of all dividends paid on new issues of corporate stock only.

if such is the case, then credits should be extended to plant expenditures as well, and statutory corporate tax rates or personal tax rates should be raised to compensate for the revenue loss.

Our investment in plant, equipment, and research provides the basis for a technological edge in international competition. It also raises the U.S. standard of living and reduces inflation pressures. Exhibit 25 summarizes the investment bang-for-the-buck of alternative stimuli and includes information on these macroeconomic impacts. For example, the exhibit indicates that a nine percentage point increase in the investment tax credit would raise output per hour by a full percentage point each decade, and it would raise the per capita living standard by $112. These incentives and impacts also work in reverse: were the U.S. to eliminate the current investment tax credit, these are the losses which the U.S. could reasonably anticipate by 1995.

Required Adjustments in Trading Partner Policies

The single greatest handicap to U.S. international competitiveness is the prospect of federal deficits equal to 5% or more of our GNP for the foreseeable future and the overvalued dollar which this prospect generates. Our extreme fiscal stimulus forces monetary policy to be less expansive than could otherwise be the case. The impact of this domestic policy conflict is magnified by its inconsistency with foreign fiscal policies: according to the OECD, "the most striking feature of the current fiscal policy climate remains the continuing disparity between the expansionary fiscal stance of the United States and the general move towards fiscal restraint in the other OECD countries."* For the period 1980 through 1985, the OECD estimates that U.S. general

*OECD Economic Outlook, December 1984, pages 27-30.

government fiscal stimulus (federal stimulus minus state-local restraint) has been on the order of 4.3% of GNP, in sharp contrast to restraint equal to 3.2% of GNP in Japan, 4.2% in Germany, 1.2% in the United Kingdom; France, Canada, and Italy have alternated between bouts of stimulus and restraint such that the average for these six major trading partners is a shift toward restraint equal to 1.7% of their GNP.

Our trading partners have had the political freedom to pursue such policies because their exports to the U.S. have been so strong. The problems created by large prior deficits have given them further incentives. Their monetary policies have tended to be conservative as well, motivated by a strong anti-inflation sentiment in the U.K. and Germany and by a general desire to prevent embarrassingly rapid declines in their exchange rates.

As the U.S. attempts a transition toward greater fiscal restraint, our trading partners should be encouraged to shift moderately toward stimulus in taxation, expenditure, and financial policies. The best global configuration would be a net shift toward fiscal restraint and a simultaneous net shift toward greater liquidity. The former would expand the global supply of savings; the latter would cut the costs of funds and support final demand to encourage the private investment demand for these funds.

At the same time, the U.S. must push aggressively for reciprocity in access to goods and service markets, respect for proprietary technologies, and open capital markets. The U.S. must not let our fully mature industrial trading partners plead "domestic political constraints" as reasons for limiting U.S. sales of agricultural goods, telecommunications apparatus, business services, and other potentially strong U.S. export areas. This is particularly unfair when those industries receive open access now or at later dates to U.S. and third-country markets. As a case in point, if the U.S. can open its automobile

market fully to Japan, given the temendous threat this posses to employees and shareholders in the large U.S. auto industry, then Japan cannot ask for shelter for its industries, mature or under development.

A logical, but admittedly extreme, answer to a country which does not deliver reciprocal access might be an across-the-board tariff on U.S. imports of all of the recalcitrant partner's products, with the tariff revenues split between rebates to the general U.S. taxpaying public (household and corporate) and export subsidies on U.S. goods shipped to that country. The rebate would partially compensate the American consumer and producer for the higher cost of goods due to the tariff, and the export subsidies would partially compensate American industries for their burden in competition with that country in other markets. The tariff and the U.S. export subsidy would anger our "partner," but it should also build political pressures within that country to eliminate the shelters for isolated industries. Other trading partners of the U.S. would be affected indirectly, benefitting from less competition in the U.S. market due to the single-country tariff but facing greater competition from U.S. products where the subsidy applied. All negotiations and policy directions on such topics would benefit from the existence of a single cabinet-level department of international trade.

SUMMARY

Given our natural resources, the U.S. is not nearly as competitive internationally as it has been in the past or could be today. Our position is handicapped by the overvalued dollar, inadequate capital formation, and insufficient bargaining pressure on our trading partners to grant reciprocal access to their markets and technologies.

Strong growth over the past two years should not be misinterpreted as a sign that the U.S. is fully attaining its economic potential. Indeed, our labor force and our industrial base are being utilized at levels that history would equate with a recession. The sharp appreciation of the dollar since 1980 has cost two million jobs--1.5 million in manufacturing alone--and cut national output by 4%. In 1984, the total input cost to a Japanese manufacturer averaged only 71% of his U.S. counterpart; this cost advantage is buying market share and providing the Japanese with the profits to fund future enhancements of their productivity and technology.

The pervasive losses of market share by American firms and the traumatic shutdowns of domestic manufacturing capacity are avoidable mutations of the normal evoluation of an industrial economy. To put the nation back on its optimal growth path, domestic fiscal policies must be carefully adjusted to bring down the cost of funds in the United States, thereby enhancing fixed investment and returning the dollar to a competitive value. The support of the Federal Reserve is also necessary: its anti-inflation zeal must be tempered by the need to accommodate a full measure of real growth and a reasonable exchange value of the dollar. Moreover, our international partners must be firmly asked to adjust their trade, monetary, and fiscal policies as well.

U.S. policy must catch up with the realities of an open global economy. Our actions must be as competitively-tuned as those of our strongest competitors.

Manufacturing Job Losses by State Resulting
from the Dollar's 1980-84 Appreciation
(Difference in current levels comparing "Stable Dollar"
scenario with "Strong Dollar" forecast)

	Percent	Thousands
7.5% or Greater		
South Carolina	13.3	50.5
North Carolina	11.7	96.5
Georgia	11.7	63.2
Alabama	10.5	37.7
New Mexico	9.9	3.7
Mississippi	9.3	20.0
Rhode Island	8.8	10.4
Utah	8.4	8.3
Tennessee	8.3	42.4
Virginia	8.1	34.6
Pennsylvania	7.9	91.8
Michigan	7.8	75.2
New York	7.7	104.4
6.1% to 7.5%		
Connecticut	7.3	31.3
Kentucky	7.2	19.1
Washington	7.1	21.1
Massachusetts	7.0	46.7
Oklahoma	7.0	13.0
California	6.8	143.7
Missouri	6.8	29.1
Texas	6.6	68.9
Indiana	6.6	41.4
New Jersey	6.5	49.2
Florida	6.5	34.0
Maryland	6.5	14.4
Kansas	6.5	12.3
West Virginia	6.4	6.1
Arkansas	6.4	13.8
Ohio	6.3	73.2
Maine	6.3	7.0
New Hampshire	6.2	7.8
5.1% to 6.0%		
Oregon	6.0	12.2
Arizona	6.0	10.9
Louisiana	5.9	11.2
Illinois	5.6	57.1
Wisconsin	5.5	29.1
Colorado	5.5	10.9
Delaware	5.4	3.8
Iowa	5.3	11.5
Vermont	5.3	2.7
Montana	5.3	1.2
Minnesota	5.2	20.5
Nebraska	5.2	5.0
5% or Less		
Idaho	4.4	2.5
South Dakota	4.2	1.3
North Dakota	4.0	0.6
Nevada	3.5	0.7
Wyoming	3.0	0.3
Alaska	2.0	0.2
District of Columbia	2.0	0.3
Hawaii	1.3	0.3
Total United States	7.2%	1,453.0

Addendum to "The United States as an International Competitor" presented to the Joint Economic Committee, by Roger E. Brinner

Senator BENTSEN. Mr. Brinner, that's a very candid and tough report and obviously will end up somewhat controversial. It seems to me that what we're seeing thus far and what has been offered under the name of tax reform is legislation which is 180° different from what this Congress passed and the administration proposed in 1981. Back then, unlike today, we were talking about increasing the tax flow to encourage investment in equipment, in plants, to modernize the productive capacity of this country.

Let me understand what you're saying. You're saying this new tax course will actually hurt the modernization of the productive capacity of this country?

Mr. BRINNER. Taking the first draft of the Treasury tax reform proposal, for example, it recommended a switch from high-powered incentives to low-powered incentives, from investment tax credits on equipment and accelerated depreciation to a general statutory rate cut. That has a problem in itself as I mentioned in the bang-for-the-buck analysis.

Even if that were revenue neutral, it would hurt capital formation. On top of that, they propose a $30 billion swing of cash flow from the corporate to the household sector. That will obviously reduce national savings and investment. So is that problem of which you speak.

As I recall the hearings on the accelerated depreciation and on the capital gains taxation and on the investment tax credits, many of those were justified on the basis of the inflation that existed in the 1970's and beginning of the 1980's. That was certainly one of the main arguments for accelerated depreciation and for the exclusion of 60 percent of capital gains.

That inflation is no longer with us, but we've found a new reason to support those kind of special incentives; namely, the high cost of U.S. funds due to the deficit.

If we could bring down U.S. interest rates and hence the cost of funds, then you could afford to try some of these tax reform proposals. But if you do them, if you remove these special incentives when we have the current handicap of a real cost of funds 4 to 5 points above our competitors, then you really are going to inhibit U.S. competitiveness by hurting our capital formation.

Senator BENTSEN. You're talking about these high interest rates and how they have helped push the dollar sky high. The administration has been intervening in foreign exchange markets as you know, to see if they can moderate the dollar. In the past, the administration has urged the Japanese to open their domestic capital markets to drive the dollar down as well. To some modest degree recently, they have followed the White House advice and have deregulated some of their financial activities. The only problem is they save about 20 percent of their income. So now, instead of U.S. investment going to Japan, they're taking all that savings and are investing it where they get the highest yields—right here in the United States. In fact, the Japanese insurance and brokerage houses are investing abroad at a pace of $100 billion annually now. That's comparable to the peak OPEC capital export surge in 1980.

The only problem is it looks like these Japanese credit exports are going to expand rather than decrease as OPEC investment did.

Does that large new source of capital, half of which is coming here, make the U.S. economic situation more stable or less stable?

Mr. BRINNER. It means that we've been able to have more capital equipment located in the United States than if that flow had not been available. But it's not owned by us. Either directly or indirectly, it's owned by someone else. That's why I don't take much comfort in the notion that we have been able to attract this foreign capital and in fact we have cut back massively in our foreign lending to finance the placement of capital here in the United States.

Senator BENTSEN. That money doesn't come here free. We're borrowing it. We have to pay for it. Some day we have to pay it back by one means or another, and we have to pay the interest on it in the meanwhile.

Mr. BRINNER. That's why I used the fourth mortgage example. Every year our Federal Government borrows not only the interest that was owed on last year's debt but then an extension of the principal, and we can't continue to do that. If we simply borrowed the interest due on last year's debt, then the debt-to-GNP ratio would stay roughly stable. It would rise slightly at today's high interest rates. But the fact that we have to borrow even beyond that interest means that our dept-to-GNP ratio keeps rising. That is not a situation we can sustain, which is very prone to six to eight quarter cycles in the economy because it's like two people riding in a car with one person riding the brake and the other the accelerator—fiscal policy pressing down hard on the accelerator and monetary policy has to resist it with the brake.

Senator BENTSEN. Now we had a decline Friday and again Monday in the yield of U.S. Treasury bills. It caused the dollar to decline somewhat on foreign exchange markets. Some of that decline is attributed to the recovery slowing down here, too. What's your best estimate on a growth recession or just plain recession next year?

Mr. BRINNER. Next year we're betting on a growth recession because I think monetary policy has been rather gingerly riding the brake, stepping down when they feel the economy is gaining too much speed but then giving us some extra impetus, as much as they can, when they see a weakness.

I think a classic recession requires us to get to a boomlike state to be followed by a bust. Because I don't see a boom in the cards, I don't see a genuine traditional recession in 1986.

Senator BENTSEN. Mr. Jefferson, certainly your testimony and the DRI report give us good advice. We certainly do need to tackle this deficit in a bipartisan way and we need that White House leadership too. I'm just not sure anyone down there wants to listen. You say we're like a kid on a spending spree with his father's credit card. I agree, a day of reckoning has to come. We just have not repealed the basic laws of economics.

Mr. JEFFERSON. I think it's partly here already. If I look at capacity utilization compared with last year our industrial plant utilization is down now. The economy grew 4.9 percent in total in the fourth quarter, but industrial production was down 1.2 percent.

Senator BENTSEN. You also discussed tax policy. Do you favor exchanging the existing investment tax credit and depreciation

schedule for lower corporate rates as the administration has proposed?

Mr. JEFFERSON. I think the Secretary of the Treasury has already raised questions about the original Treasury proposal, concern about the capital cost recovery and investment tax credit provisions. Just what will emerge in April, I don't know, but at least that is being looked at.

Clearly, if you do away with ITC and ACRS, you will be back with an even less competitive use of cost of capital than we have enjoyed, which was one of our biggest problems prior to the introduction of the accelerated cost recovery. That was partially corrective and if we reverse it, then our cost of capital problem that Mr. Brinner has referred to will be more acute.

I think as it's presently designed the tax reform is unsound from the standpoint of international competitiveness.

Senator BENTSEN. You think it's a step backward?

Mr. JEFFERSON. Yes.

Senator BENTSEN. I was noticing in your statement that you say, "Protectionist measures increasingly advocated as trade problems worsen should be avoided if at all possible. However, other nations are using nontariff barriers to protect their markets. We must insist that our trading partners provide reasonable access to their markets if we are to continue to provide them access to ours."

Mr. Jefferson, the problem I face is I've been a freetrader all my life. I have pushed for that and I have believed in that and I must say I have a great respect for the way the Japanese can tackle economic challenge. I think they are obviously some of the best negotiators we deal with and some of the toughest that we deal with. But I have come to the conclusion in watching what actually happens that what they are interested in is not so much having free trade as having a free hand in what they are doing now.

When you say we must insist on reasonable access, how do we insist? How do we put some muscle in it?

Mr. JEFFERSON. Well, I think that's really a question of the degree of backbone at the bargaining table on these matters. I suppose they are approached with all kinds of views. There's the diplomatic view. There is a trade view. There is probably a Treasury economic view.

One of the problems we have is that our trade policy responsibilities are very fragmented and you have the situation now in the case of Japan following the visit of Prime Minister Nakesone, broad oversight of that trade matter is with the Department of State. There are a lot of people in this act. So I think we need a good focus for the setting of policy and we have to be tough.

There is no reality of free trade. We're unlikely ever to see it. But GATT, when it was established afer World War II, was very successful for a long time. I suspect in part because of the spirit of the agreement. We had a tremendous increase in world trade in the following 20 to 25 years. This has in recent years moderated and I think what has happened is that some countries no longer play by the rules. There are evasions. The nontariff barriers have been much discussed. There are discriminatory investment policies in some cases.

When you add it all up, we are far from free. The point I was trying to emphasize was that access to our very large, attractive market is pretty open and we should, as we go down the list with other countries, be pretty insistent on comparable treatment. But there will always be special cases. There will be developing countries situations where some forebearance would be needed, but with highly developed contries we need to be tough.

Senator BENTSEN. Mr. Jefferson, what I'm concerned about is that Japanese mercantilism has become an example to the so-called developing countries. They don't look to the United States and free trade as the example on trade policy. They really look to Japan and they see a country that has done a remarkable job in developing their products, boosting their quality, and protecting their markets as they develop those products. They see the Japanese going in and targeting areas in our country. They see our country and I think they then look at Japan as the example to emulate.

My concern is that you're going to see the Japanese mercantilist model repeated over and over in those countries and that makes it all the tougher for us to support free trade.

The other problem it seems to me we run into is the IMF going into the Third World countries, the lesser developed countries, where they're having credit problems, and saying, "Now you have to cut back on your imports and you must increase your exports." Then we look at where those imports are from and whose they cut off. They have been cutting off imports from us. Moreover, their exports are up. But, Japan is not taking that increase in exports. They're coming here. That's what concerns me, as well.

Mr. JEFFERSON. Senator Bentsen, I suppose the need for exports came to other countries before it came to us, but it now has became a matter of magnitude, as I mentioned in my remarks, that our economic policy can no longer be rather narrowly drawn with prime concern about domestic affairs. The design of the economic policy has to embrace our international trade as well.

I think a good case can be made that in its design for quite a number of years matters of international competitiveness and trade have not received high priority at all.

Senator BENTSEN. Well, you were talking about how this worked immediately after World War II with GATT. But then we were the dominant economic power in the world with no one even approaching us. Number two was way down there. That's not the case any more. We were very generous during that period of time because we could afford to be. But now Europe and Japan have caught up, and in some ways they have surpassed us. It seems to me that Japan is really misinterpreting the strength that they think comes from a great trade surplus. I know of no nation more vulnerable to protectionism from other countries than they are, no nation more vulnerable than they are.

Now if they wanted real sentiment on their side in this country to fight against any kind of limitation on their products coming in, they should allow more imports. We would say, "Look, don't put any limitation on Japanese products coming in here because they will reciprocate and stop ours." I think that would be the smart economic viewpoint for them to take.

As it is now, I think they have achieved great vulnerability for their economy.

Mr. JEFFERSON. I would agree with that.

Senator BENTSEN. I'm advised by staff now that the numbers are that we now take 60 percent of non-OPEC LDC exports and Japan takes 8 percent. So they are not sharing in the problem of trying to help these lesser developed countries recover and get their credit back in balance.

Mr. BRINNER. I might expand on your statistic. If you broke that down further into finished manufactured goods versus raw materials and semifinished, you would find that Japan's contribution is even weaker. They are a great country for importing raw materials and very simple manufactured goods but keeping their market closed to the more refined goods. The problems that we face with Japan are shared by the LDC's.

Senator BENTSEN. Mr. Brinner, there is no question about that. This country went through that problem of economic colonialism—of providing the raw materials and receiving back manufactured products—back in the colonial era. In those days, we were called a colony. If we don't watch it, we're going to get back in that same kind of status of providing just raw materials, and that means all of the high paying jobs are over there, not here.

I would like to yield to my distinguished colleague, Senator Proxmire.

Senator PROXMIRE. Thank you very much, Senator.

Mr. Jefferson, you're the chief executive officer of Du Pont as I understand it.

Mr. JEFFERSON. Yes.

Senator PROXMIRE. And we're very honored to have you here. You're doing a fine job.

What assurance could you give the subcommittee that a reduction in the deficit will not slow economic growth? If it does slow economic growth significantly, I'm afraid that Congress will lose any stomach for it. You see how hard it is now to cut spending. You can imagine how difficult it is if we move into a period of stagflation or recession when unemployment is increasing. Mr. Brinner indicated that the outlook in his view was for a period of stagflation.

Let me just give you the case that a reduction in deficit will do that. Number one, it would mean a reduction in the stimulus of tens of billions of dollars, a stimulus that on the basis of the experiences in the last 3 years has caused—at least has been a factor in causing economic expansion. It would slow down foreign recovery. Obviously, if the value of their currency begins to increase and ours fall, they will be exporting less to us and we're an enormous market, probably the most important market in the world, and it would be particularly difficult for the lesser developed countries.

In spite of that, we would have the peculiar situation, the reverse of what we have now, of a recession in which prices would tend to rise because we would have the reverse of what we have now. That is, there would be a tendency for import prices to go up, there would be less competitiveness in imports, and therefore, the prices might go up under those circumstances; and if they did, interest

rates, instead of falling as they normally do in a recession period, might follow inflation up which it normally does.

It seems to me this is a pretty formidable, dismal outlook that I sketch here, but it's something that's in the back of the minds of all of us, although it's not always expressed.

What can we do to counteract this?

Mr. JEFFERSON. Senator Proxmire, as I'm sure you realize, you're dealing with relative risks here. To be sure, there is a risk as you curtail the present overexpenditure or take other actions to bring the Federal budget into better balance. There are risks of short-term softening effects on the economy. But that may be a necessary price to pay for sustained long-term healthy growth.

We are heading at the moment toward some very, very difficult times if we become a debtor nation at the rate we appear to be trending. By the end of the decade, we would owe more than all the debtor nations combined today and what kinds of unsettling world economic effects that would have, I don't know. I'm not an economist. But one thing I'm aware about the science of economics is that it doesn't predict rates very well. In fact, it doesn't.

Senator PROXMIRE. It doesn't predict anything very well.

Mr. JEFFERSON. It's like thermodynamics in chemistry. It can tell you when you're finished with equilibrium, but it can't tell you how fast you'll get there. So I would hesitate to predict.

I have to believe there are a set of precepts for what is a healthy, well-managed economy, and large debtor spending as we are currently engaged in, with its clear impact on impairment of our international competitiveness, has to be wrong.

Whether in getting to sustained healthy growth we have to give up for a period some consumption in the interest of greater investment, I suspect we probably do.

Senator PROXMIRE. You see, the political problem as it comes to us is that we have—many Americans don't just give up consumption; they give up their jobs. We have 8.5 million people out of work now, 7.3 percent of the work force, and if we have a period of stagflation of the kind Mr. Brinner described, even if we grow at 2 or 3 percent which I guess would be a stagflation situation, on the basis of previous experience that's not enough to keep our work force working and the unemployment would rise. There is where you get the pressure on Congress—job programs, WIN programs, all kinds of expenditures because the people out there don't have jobs and one thing Americans want more than anything else is an opportunity to work and we don't give it to them.

Mr. JEFFERSON. Senator, that worries me too. Although we have had quite a successful program of creating new jobs and reducing unemployment, we're still not where we were in terms of percentages in 1979, and the unemployment among youth and minority youth is a problem that is still not properly resolved.

The answer to that has to lie in new job creation and that is a matter of investment and it's a matter of redressing some of the present excesses that are hurting us and have prospects of hurting us worse than we've been talking about this morning.

Senator PROXMIRE. Mr. Brinner, can you work up a table or do you have statistics available showing the gross economic effect, including the loss of agricultural sales, from the bloated dollar?

Mr. BRINNER. Yes.

Senator PROXMIRE. I think that would be very, very helpful to us because this table is excellent and we can use this effectively I think in persuading people in the Congress to understand what's happening to this country with the deficit and the consequences of the deficit, but the farm effects have a very powerful effect and it seems here that a lot of these States are not really suffering very much and we know they are.

Mr. BRINNER. Certainly on the agriculture we'll have to give you another submission. There is a summary table of the broad economic impacts that goes along with the manufacturing impacts on page 19 that gives you the real GNP, consumption, investment indications. For example, 4 percent loss, as I mentioned, on real GNP.

If I might just briefly respond to your challenge on the short-term impact of a deficit, I would agree with you that if you don't provide some offsetting stimulus from domestic monetary policies, foreign monetary policies, foreign fiscal policies, that each $50 billion in deficit closing will tend to cut real GNP by 1 percent.

Senator PROXMIRE. Mr. Brinner, you have a lot more confidence in monetary policy than I do or McChesney Martin, probably one of our greatest Chairman of the Federal Reserve Board, had. He used to say, "You can't push a string." People would say, "Why can't you expand the economy by reducing interest rates?" And of course what happens when you get into this kind of a situation, no matter what you do to increase interest rates with inflation going up, the Federal Reserve is really much more limited than those of us who aren't on the Board believe it is.

Mr. BRINNER. Well, the Federal Reserve I think has changed its opinion on that. I have spoken to presidents of the local boards and to the members of the Board of Governors, and the experiences of 1980 and 1982 leads them to think that this isn't a string situation any more. You will recall in the spring of 1980 the Wall Street Journal said, "We're in a free fall. The economy is falling because of a tight monetary policy." The Fed loosened up, dropped interest rates well down in the single digit zone and guess what? The economy came back in a quarter or less. Then again in 1982, it took us into a recession and then they saw that it was getting to be very traumatic, they loosened up and we came back.

Monetary policy is no longer as one sided as it once was. So that if the deficit closing is taken on a measured basis over a prolonged period, monetary policy can buffer it. But I still say—I agree with you—the loss in GNP, four quarters after you begin each $50 billion deficit closing is on the order of 1 percent which will cost you a half a percent on employment.

Senator PROXMIRE. Well, you're a brilliant economist, but I still don't accept that posthope reasoning you have that because we had a recovery that monetary policy was good at the time.

Let me ask you this. How refined are your inputs? I noticed at the very top of the chart you have South Carolina and North Carolina as the States that lost most manufacturing per capita. Now, as you know, they're the two States that have the most manufacturing, period. And the kind of manufacturing they have, though, they

don't have much in the way of automobiles, they don't have much in the way of steel. They have a lot of furniture.

Mr. BRINNER. Textiles and apparel.

Senator PROXMIRE. Some textiles. But by and large, it's not viewed at least usually as affected by foreign competition as the industries in Michigan, Ohio, and some of the other States.

Mr. JEFFERSON. Senator, I think it's the textile problem that affects them most. They are very, very heavy in textiles.

Senator PROXMIRE. Well, that's true.

Mr. BRINNER. In fact, that is how this table is constructed. We evaluated the national impact industry by industry and then translated that industry impact down to the States based on the State's involvement in those industries. So it was a top-down analysis that fed through to the State-by-State numbers that you're looking at. That's why I elected to group them in these categories—7.5 percent or greater. I would stress that these show, first, that there's a widespread problem. It hits every region and in fact some surprising ones, and that there are some States that have been hit very hard.

I wouldn't, you know, be upset if you challenged South Carolina's ranking as No. 1.

Senator PROXMIRE. Well, North Carolina is No. 1 in manufacturing. You have South Carolina as No. 2. But it's almost the bottom in per capita income. It's fascinating. They have a very high percentage of manufacturing jobs and they are 48th in per capita income.

At any rate, let me ask you this. You make a strong case for aggressive taxes and I noticed Mr. Jefferson also advocated a value-added tax—didn't advocate it necessarily, but indicated a value-added tax might have some advantages with respect to imports.

The difficulty with pursuing this is that the inequities seem so patent and conspicuous. Here you have a situation where you have 65 big corporations with an income of $49 billion net income, net profits, from 1981 to 1983, in aggregate, that paid absolutely no income tax at all—none, zip, zero. Our biggest defense contractor, General Dynamics, has paid no income taxes since 1972 while they enjoyed $1.6 billion in net profits and they will pay no income taxes according to most projections until the year 2000, even though they are going to enjoy about $3 billion or so in profits during that period.

Now it's very hard under those circumstances to say that the accelerated depreciation and investment credit which are in part responsible for this—they play a big part—therefore, are provisions that we can defend when we talk to the normal taxpayer in this country. He just thinks, after all, if people are making that kind of money they ought to pay taxes. Maybe we ought to abolish the corporation income tax. In fact, I would favor that. But we're not going to. We can't afford it now. So many corporations have to pay 30 or 35 percent of their net income in taxes.

So if we can't and shouldn't abolish accelerated depreciation and investment credit, would you feel that it would be devastating for us to have a minimum tax with real guts with no exceptions at all, just put right on that net income, say, 15 percent, that you had to pay it. As long as you had a net income, you pay at least 15 percent or 20 percent?

Mr. BRINNER. A minimum tax created in that way would in the language that used to be applied to capital gains poisons the incentives of the accelerated depreciation or investment tax credit. So it would give you the same bang for the buck. If people are looking at their last decision as being a piece of equipment that only the presence of the investment tax credit or maybe a leasing provision associated with the tax credit allowed them to make and the minimum tax says, "But you won't get the benefit," that won't take place. So in the most extreme case, this minimum tax could poison.

I suppose to get at your equity issue I would be more in favor of, say, a manufacturing value-added tax, one that relates not to income or equipment purchases but to total value added of the manufacturing enterprise. It might also be debatable under the terms of GATT, although I should point out that you would anticipate some exchange rate movements to offset any total national value-added tax that might be rebated on exports.

Senator PROXMIRE. What gives me a lot of trouble on the value-added tax is it's invisible and we need the discipline and pain of taxation it seems to me as part of the instrument to hold down spending. If you don't have that, people say, "What's the difference, let's go ahead with the value-added tax." It's reflected in the prices but you don't really know the tax is there and it is.

Mr. BRINNER. It only shows up in the first increase.

Senator PROXMIRE. I have one final question here. On your U.S. international manufacturing costs you have a series of tables showing the United States in pretty bad shape as far as average hourly compensation, output per hour, unit labor cost, and so forth. Then you come down to the final 17(d) foreign total costs in relation to United States, and we don't look so bad. As a matter of fact, in 1984 we're better off than we were in 1974 with respect to Germany and our costs are equated at both 100.

Mr. BRINNER. That's correct.

Senator PROXMIRE. And the United Kingdom, we're not as well off as we were before but we're better off than they are. Theirs has gone up to 105 and ours is still 100. Only with Japan of the four you list here are we worse off.

Mr. BRINNER. My export share analysis——

Senator PROXMIRE. Even after all these deficits and all the other problems.

Mr. BRINNER. The export share analysis backs up your observation, that our problem is not that we can't compete with the Europeans. We're still doing pretty well competing with the Europeans. Our technology looks pretty attractive compared to theirs.

Our problem is Japan, Korea, Singapore, and Taiwan—the newly developing, industrialized countries. I did not make the equipment costs, the financial costs calculations to allow me to add them to the labor cost. But if you look at the labor cost, you see Korea 56 percent of the United States on unit labor cost. So we do have a problem against particular competitors.

Senator PROXMIRE. No question on the labor cost, but when you say total costs—energy, et cetera——

Mr. BRINNER. No problems against Europe.

Senator PROXMIRE. We look a little better as far as Europe is concerned.

Mr. BRINNER. 170 yen per dollar rather than 240 or 250 that's the problem.

Senator PROXMIRE. Thank you, Senator.

Senator BENTSEN. Thank you very much, Senator Proxmire.

On the point you raised about corporations not paying taxes that make a lot of money, I totally agree. I think we have or had the same problem with individuals. Some of them had been using these preference items to the point that they were making vast sums of money and paying no taxes. That destroys confidence in the tax system. So we approached that with an alternative minimum tax a while ago, and we pretty well took care of that situation, I believe. I saw a report put out the other day where about 269 people made $200,000 without paying any taxes. Once you examined that in detail, it was a misrepresentation in some ways because the vast majority of those people, I understand, were paying foreign tax and would get credit for that based on international treaties. So we have virtually eliminated it for the individual and if there's some left we ought to get at those.

But I have my staff working on an alternative minimum tax on corporations, as I know some others are, as well. What we're trying to do is to see that there is not an excessive use of these preferences. I think when that exists, it begins to destroy confidence in the system and I just think anyone—corporation, individual—making money ought to pay their fair share of the taxes. So I would appreciate your input—not at the moment—as to the design of an alternative minimum tax. As we work on this tax system, what I want to do, to the extent we possibly can, is make it more fair and to be perceived as more fair. I know of no more difficult decision than the allocation of the tax burden amongst people and I know of no area where there is greater temptation and opportunity to trample on rules of justice. That's what we must be sure we have not done in trying to develop a tax system that neither tramples on the rules of justice nor tramples on economic recovery.

Gentlemen, we've been very appreciative of your attendance here and I think it's a major contribution. Mr. Brinner, I think your report is excellent.

Mr. JEFFERSON. Might I add one point about Europe, at least a slightly different perspective from Mr. Brinner.

I happen to have two plants that you could call sister plants. One is in West Virginia and the other one is in Holland and they are alike, the same technology, the same numbers of people running them.

Under prevailing conditions the Dutch plant has a 15-cent-per-dollar denominated cost advantage. These numbers are all very complex but that's a rather simple case because they are the same manufacturing operation in two different countries.

Senator BENTSEN. Well, that's a dramatic illustration for us.

Gentlemen, thank you very much for your attendance here. We are very appreciative of your presentations.

[Whereupon, at 11:30 a.m., the subcommittee adjourned, subject to the call of the Chair.]